Chapter 1 - Introduction

What information should companies provide to investors and creditors? To what extent should auditors be associated with that information?

The American Institute of Certified Public Accountants formed the Special Committee on Financial Reporting (the Committee) in 1991 to address those questions because of concerns about the relevance and usefulness of business reporting. The Committee's work is part of the AICPA's broad initiative to improve the value of business information and the public's confidence in it. The broad initiative seeks to:

- Enhance the utility of business reporting.
- Improve the prevention and detection of fraud.
- Assure the independence and objectivity of the independent auditor.
- Discourage unwarranted litigation that inhibits innovation and undermines the profession's ability to meet evolving financial reporting needs.
- Strengthen the auditing profession's disciplinary system.

The Committee is not a standard-setting body. It offers its recommendations for the consideration of all those that have an interest in furthering the cost-effective quality of business reporting. If subsequently pursued by standard setters or regulators, the recommendations will be subject to full due process.

Business Reporting: A Cornerstone

People in every walk of life are affected by business reporting, the cornerstone on which our process of capital allocation is built. An effective allocation process is critical to a healthy economy that promotes productivity, encourages innovation, and provides an efficient and liquid market for buying and selling securities and obtaining and granting credit. Conversely, a flawed allocation process supports unproductive practices, denies cost-effective capital to companies that may offer innovative products and services that add value, and undermines the securities market.

Without adequate information, users of business reporting cannot judge properly the opportunities and risks of investment opportunities. To make informed decisions, they need a variety of information, including data about the economy, industries, companies, and securities. Complete information provided by the best sources enhances the probability that the best decisions will be made. And for company-specific information — which is key because companies are the sources of cash flows that ultimately result in the return on securities or the repayment of loans — management often is the best source. Business reporting packages management's company-specific information and delivers it to users in a meaningful way.

**Business Reporting**
The information a company provides to help users with capital-allocation decisions about a company. It includes a number of different elements, with financial statements as one of those elements.

**Capital Allocation**
The process of determining how and at what cost money is allocated among companies.

**Users**
Investors and creditors, including potential investors and creditors, and their advisors that use business reporting as a basis for their capital-allocation decisions.

Few areas are more central to the national economic interest than the role of business reporting in promoting
an effective process of capital allocation. It simply must be made to work as well as possible.

**Business Reporting in an Era of Change**

Increased competition and rapid advances in technology are resulting in dramatic changes. To survive and compete, companies are changing everything — the way they are organized and managed, the way they do work and develop new products, the way they manage risks, and their relationships with other organizations. Winners in the marketplace are the companies that are focusing on the customer, stripping away low-value activity, decentralizing decision making, reducing the time required to perform key activities, and forming new alliances with suppliers and customers — even competitors. They are setting the pace for others that must, in turn, reexamine their businesses in light of the increased competition.

In response to increased competition and changes in their businesses, companies also are changing their information systems and the types of information they use to manage their businesses. For example, they are developing new performance measures often designed to focus on activities that provide long-term value and competitive advantage, including non-financial measures such as product development lead time and financial measures such as economic value added.

Can business reporting be immune from the fundamental changes affecting business? Can effective business reporting exclude new performance measures on which management is focusing to manage the business? In times of rapid change, the risk increases that business reporting will fall behind the pace of change, failing to provide what users need to know. Today, more than ever, business reporting must keep up with the changing needs of users or it will lose its relevance.

Highly relevant business reporting also is important for the long-term vitality of the accounting profession. Accountants — those in industry, public accounting, education, and research — are closely associated with the process of business reporting and have an interest in ensuring its relevance. The Committee’s work is analogous to the product and service redesign undertaken by many successful businesses to meet customer needs better. Cost-effective improvements in business reporting will enhance its value both to users and to the profession, just as improvements in products enhance value both to the consumer and to the producers of those products.

**The Need for Reporting Standards**

Some constituents, including many companies, while acknowledging the importance of high-quality business reporting, question the need for a study of business reporting and recommendations to improve it. They ask: Why not let the marketplace for capital determine the nature and quality of business reporting? The marketplace, they argue, already offers powerful incentives for high-quality reporting. It rewards higher quality reporting and punishes lower quality reporting by easing or restricting access to capital or raising or lowering the cost of capital. Additional reporting standards, they argue, would only distort a market mechanism that already works well and would add costs to reporting, with no benefit. They liken reporting standards to costly, inefficient, unnecessary bureaucratic regulations.

However, reporting standards play an important role in helping the market mechanism work effectively for the benefit of companies, users, and the public. More specifically, reporting standards are needed because they:

- **Promote a common understanding of terms and alternatives that facilitate negotiations between users and companies about the content of business reporting.** Today, for example, many loan agreements specify that a company provide the lender with financial statements prepared in accordance with generally accepted accounting principles. Both the company and the lender understand that term. The company understands what must be done to prepare those statements and the lender is comfortable that statements prepared according to those standards will meet its need for information. Without standards, the statements would be much less useful to the lender, and the company and the lender would have to invent for themselves satisfactory standards — which would be inefficient and less effective than using generally accepted standards.

- **Promote neutral, unbiased reporting.** Companies may wish to portray their past performance and future prospects in the most favorable light. Users are aware of this potential bias and are skeptical about the information they receive. Standards help ensure more neutral,
unbiased reporting, which, in turn, builds credibility and confidence in the capital marketplace to the benefit of both users and companies.

- **Improve the comparability of information across companies.** Without standards, there would be little basis to compare one company with others — a user goal and a key feature of relevant information. Just as “truth in packaging” regulation enables consumers to compare the contents of food products, so should standards for business reporting promote comparability of information about companies.

- **Permit audits of information.** Auditors verify that information is reported in accordance with standards; without standards, audits would be less meaningful.

- **Facilitate retrievability of information by organizing data according to a framework.** A consistent approach to organizing the presentation of information assists users in accessing information in an efficient manner and facilitates prompt decision making.

For many years, financial statements and, in the broader arena of business reporting, filings with the Securities and Exchange Commission (SEC) have been prepared following standards, producing highly useful information. Standards in business reporting have proven their worth.

The Committee acknowledges that reporting standards could inflict costs on some companies without resulting benefit. That could occur, for example, if a company was required to report information that users do not need. However, reporting standards need not eliminate flexibility in reporting, nor increase costs without benefit. The solution is not to do away with reporting standards but, rather, to design standards flexible enough to be responsive to the costs and benefits companies face in particular circumstances.

**A Focus on Users — The Customers of Business Reporting**

Businesses everywhere have renewed their focus on the needs of their customers. Satisfaction surveys, focus groups, and cooperative ventures with customers abound. The insights gained from the renaissance of customer-focused activity are driving critical improvements in the quality, cost, and responsiveness of products and services around the globe.

Just as successful businesses align the features of their products and services with the needs of their customers, so, too, should the providers of business reporting. Recognizing this, the Committee concentrated on the information needs of users to help identify and evaluate ideas for improvement.

The Committee undertook a comprehensive study to determine the information needs of users to identify the types of information most useful in predicting earnings and cash flows for the purpose of valuing equity securities and assessing the prospect of repayment of debt securities or loans. The Committee designed the study to ensure that the findings were representative of a broad group of users and to distinguish between the types of information users really need and the types that are interesting but not essential. It also considered how users' needs for information might change over time.

To help ensure representative results, the study focused on direct input from users and rejected speculative data. It also involved multiple projects, each of which analyzed information needs from a different view. Further, the study focused on information from groups in addition to individuals, including a number of surveys and documents from users' associations.

To distinguish between needed information and less important information, the Committee developed a framework of information needs based on how investors value companies and how creditors assess the prospect of repayment. It considered information consistent with the framework to be more important and other information less important. It also gathered data about the relative priority users place on different kinds of information, which helped rank potential improvements.

For a longer term view, the Committee gathered information about trends that are shaping business activity and considered the implications of those trends on users' information needs.

The Committee's study has been unique and important. Not only has it provided a foundation for the Committee's work but also the Committee hopes it will influence future agendas of standard setters and regulators and the future direction of standard-setting projects. Most important, the study demonstrated the
worth of focusing on users as a means to identify and evaluate ways to improve business reporting. Ongoing study is key to keeping pace with evolving needs for information.

**Balancing Costs and Benefits**

Improving business reporting requires considering the relative costs and benefits of various types of information. Just as costs and benefits are key to determining the features included in any product, a practical balance must be struck in weighing the costs and benefits of information.

The Committee considered the costs of providing each type of information that its study suggested users need, and it screened from further consideration the types it judged to be too costly in relation to the benefits. The screening process included discussions with financial executives of large public companies, including a working group sponsored by the Financial Executives Institute (FEI). Auditors who serve smaller companies also provided input, as did standard setters, regulators, users, and others. The screening process produced an information package designed to be both useful and sufficiently cost-effective to merit consideration by standard setters and regulators.

Weighing the costs and benefits of possible improvements to business reporting is difficult and complex. It is impossible to measure with precision many of the costs and benefits of improved disclosure, such as the cost of disclosing competitively harmful information or the benefits to the economy of another piece of useful information. In addition, the costs and benefits are widely scattered and people are affected to different degrees.

While difficult, cost and benefit decisions must be made. On the one hand, business reporting must be enhanced to maintain its relevance, while, on the other hand, undisciplined expansion of mandated reporting could result in large needless costs. Faced with this dichotomy, the Committee adopted a cautious and practical approach, proposing ideas supported by users that would result in truly useful information while recommending constraints on disclosure to restrict costs in areas where they could be significant.

The Committee believes its recommendations are sufficiently cost-beneficial to merit consideration by standard setters, which would — as a matter of course — perform further cost and benefit analyses as a part of due process.

**Recommendations**

A lot is right with today's business reporting in the United States. It generally provides users with essential information that heavily influences their decisions. In particular, financial statements are viewed as an excellent framework for capturing and organizing financial information. Users have welcomed improvements in business reporting, but few suggest the current framework should be scrapped and a new one developed.

Yet many users are strongly critical of certain aspects of today's reporting. Understanding the reasons for the criticism — much of it substantive — has identified high-priority areas for improvement. Some companies, particularly the larger ones, already provide all the information that users need, but many do not. Those that do, provide it in a variety of ways rather than in a comprehensive, integrated format.

Based on the information needs of users as well as the costs and benefits of potential improvements, the Committee developed recommendations to improve business reporting. Key points about those recommendations are:

- To meet users' changing needs, business reporting must:
  
  (a) Provide more information with a forward-looking perspective, including management's plans, opportunities, risks, and measurement uncertainties.

  (b) Focus more on the factors that create longer term value, including non-financial measures indicating how key business processes are performing.
(c) Better align information reported externally with the information reported to senior management to manage the business.

- Users believe auditor involvement with financial information is essential. To serve its customers better, the auditing profession should prepare to be involved with all types of information in business reporting to the extent companies and users may decide is necessary.
- Participants in the business reporting process must do a better job of anticipating change by:
  
  (a) Focusing on users' information needs and finding cost-effective ways of better aligning reporting with those needs.
  
  (b) Developing and maintaining a comprehensive model of business reporting reflecting the kinds of information that users need (the Committee has designed and illustrated such a model).
  
  (c) Adopting a longer term focus by developing a vision of the future business environment and users' future needs for information.

- The current legal environment discourages companies from disclosing forward-looking information. Companies should not expand reporting of forward-looking information until there are more effective deterrents to unwarranted litigation.

**Organization of This Report**

This report is in three parts. The first, chapters 2 through 4, presents the foundation on which the Committee's work is based. Chapter 2 discusses the Committee's study of users' needs for information. Chapter 3 outlines the central themes underlying the information needs of investors and creditors. Chapter 4 discusses the benefits and costs of business reporting.

The second part, chapters 5 through 8, discusses the Committee's recommendations and the bases for those recommendations. Chapter 5 discusses recommendations to improve the types of information included in business reporting and the Committee's comprehensive model. Chapter 6 discusses financial statements and related disclosures. Recommendations about auditor association with business reporting are discussed in chapter 7. Facilitating change is the subject of chapter 8.

The third and final part consists of appendices I through V. Appendix I summarizes the Committee's recommendations. Appendix II presents the Committee's model of business reporting. Appendix III presents a business report illustrating the reporting principles of that model. Appendix IV provides background information about the Committee. Appendix V describes the contents of the Committee's database of materials on users' needs for information, as discussed below.

**Other Materials by the Committee**

In addition to this report, the Committee has produced a brochure that summarizes the Committee's work and recommendations. It also has built a substantial (1,600-page) database of its research on the information needs of users that includes source information and analysis. Copies of the brochure and the database, as well as additional copies of this report, are available from the AICPA.
Suggestions to improve business reporting are plentiful. However, many are based on existing concepts of business reporting that may or may not be consistent with users’ needs for information, and many that purport to be consistent are based on speculation or intuition and not on direct evidence.

Accountants rarely have measured the quality of business reporting directly with users. Instead, they have developed concepts and frameworks they believe are consistent with information needs and thus usually judge ideas to improve reporting based on the degree of their alignment with existing concepts rather than on more direct verification with users.

That approach, however, carries certain risks—the risk the reporting concepts are not closely aligned with information needs (which is particularly high during periods of rapid change, when information needs evolve and the concepts fail to keep pace) and the risk that, over time, accountants will become more tied to the concepts and lose sight of the real goal (which is to meet the information needs of users at an acceptable cost).

Standard setters have tried to reduce these risks by seeking to learn directly from users about their information needs. Unfortunately, that effort has been only partially successful because high-quality documentation about information needs is scarce and users have been reluctant participants in the standard-setting process.

The Committee decided that its understanding of users’ information needs should be based on facts rather than merely on speculation or intuition. To get those facts, it methodically studied users’ information needs to identify the types of information users believe are the most useful in valuing securities or assessing the prospect of repayment of debt securities or loans.

This chapter discusses that study. The first part covers the types of users on which the study focused. The second describes the diverse projects the Committee undertook to learn about the information needs of users. Subsequent sections identify areas for further study, the Committee’s analysis of the data, and the limitation of the study.

**Types of Users**

The study focused only on certain types of users — specifically, professional investors and creditors and their advisors, which follow fundamental approaches and which cannot compel a company to produce the information needed for analysis. The study also restricted its focus to users’ evaluations of only certain reporting entities — specifically, to-for-profit entities. That focus is discussed below. As used in this report, the term user refers only to the subset of users that are the focus of the Committee’s study.

**Investors and Creditors**

People use business reporting for many reasons as illustrated by the following examples:

<table>
<thead>
<tr>
<th>Type of User</th>
<th>Reason for Using Business Reporting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investors</td>
<td>Help with investment decisions</td>
</tr>
<tr>
<td>Creditors</td>
<td>Help with credit decisions</td>
</tr>
<tr>
<td>Management and board members</td>
<td>Help with decisions about managing the business</td>
</tr>
<tr>
<td>Employee groups</td>
<td>Help understand compensation policies and a company’s ability to meet compensation and benefit commitments</td>
</tr>
<tr>
<td>Competitors</td>
<td>Help evaluate competitive strengths and weaknesses and business strategy</td>
</tr>
</tbody>
</table>
Regulators  Help assess compliance with regulations
Academics  Provide data for research
The press  Provide data for articles
Users concerned with various social causes  Help assess a company’s involvement in areas of concern

The Committee decided for two reasons to focus on improving business reporting to help users with investment and credit decisions: (1) the AICPA formed the Committee primarily to address concerns about the relevance of business reporting in making investment and credit decisions and (2) the primary focus of business reporting has been to assist users in making those decisions, thereby helping ensure that capital is allocated efficiently and effectively. The Committee decided that the traditional role served a critical function and should be preserved.

Professional Users

For a variety of reasons, the Committee focused on the information needs of professional users rather than non-professionals who use business reporting to make decisions for their personal benefit and not as part of their employment:

- Professionals generally base their decisions on superior models and methods. The skill and resources at the disposal of professionals and the institutions that employ them are greater than those available to other information users.
- The amount of total capital that professionals control has increased dramatically in the last two decades, a trend resulting in part from the popularity of mutual funds, which concentrate large amounts of capital under the control of relatively few professional users.
- The increasing complexity of the marketplace and accelerating change may cause even more non-professional users to rely on the advice of professionals — including brokers, analysts, and others — in making decisions, thereby increasing the influence of professionals in allocating capital.
- Because of their training and full-time focus, professionals should be better able to articulate their needs for information and the related reasons for those needs. Professionals also more fully standardize and document their procedures. Studying their activities provided the greatest likelihood of learning how to improve business reporting most efficiently.

Advisors

The Committee also considered whether to focus on the users of business reporting that advise investors and creditors, even though they are not investors or creditors themselves. The Committee concluded such advisors (which include analysts, brokers, portfolio strategists, industry consultants, and others) often serve an integral role in investors' and creditors' decision-making processes. Further, it noted that certain advisors, particularly analysts, are among the most important users of business reporting. Thus, the Committee decided to consider the information needs of advisors to investors and creditors, particularly analysts, to the extent their approach to developing advice requires information from business reporting.

User Approaches to Decision Making

Not all users rely on business reporting to help with their investment and credit decisions. Users' particular decision approaches in large part determine the extent to which they use information in business reporting.

Some approaches require no direct information from business reporting. Examples include:

- **Index fund approach.** Users try to duplicate the performance of an index, such as the S&P 500. The types of information needed include the identities of securities necessary to mimic the index's performance.
- **Approaches that predict future price changes for securities based on historical patterns of securities prices or historical correlations of securities prices to certain phenomena.** These
approaches often use charts and graphs as tools to understand those historical patterns and correlations.

- Technical approaches that predict short-term changes in the supply or demand of particular securities as a means to predict changes in the prices of those securities. The types of information needed include, for example, the number of shares of a security sold short, the margin position of a security, purchases or sales of a security by insiders, and other leading indicators considered useful for predicting changes in the supply of and demand for securities.

In contrast, other approaches require extensive amounts of company-specific information of the types commonly found in business reporting. Examples include:

- Fundamental approaches that seek to value a security by assessing the amount, timing, and uncertainty of future cash flows or income that will accrue to the company issuing that security.
- Anticipation approaches that predict a company’s short-term earnings, changes in earnings, and changes in trends of earnings as a means to predict short-term changes in the prices of its securities.

The Committee focused on users that follow fundamental approaches because those approaches generally require information from business reporting. Anticipation approaches have information needs that are either the same or a subset of those of the fundamental approaches. Thus, the Committee concluded that a separate study of users that follow the anticipation approach was unnecessary.

### Ability to Compel or Negotiate for the Information Needed

Some users can compel or negotiate for companies to deliver the information they need for analysis. Examples include investors with large ownership; users with sufficient bargaining power, such as venture capitalists; bankers when considering loans to risky credits; and rating agencies. On the other hand, other users cannot compel or negotiate for the information they need. They must rely on mandated reporting, the willingness of a company to provide information, and sources outside a company for the information needed to make decisions. Those that can compel or negotiate for such information — such as representatives of rating agencies — generally obtain what they need without the intervention of standard setters or regulators. Thus, the Committee concluded that it should focus on users that cannot compel or negotiate for information. However, it decided to include other users as well for two reasons:

1. The information needs of both groups probably are similar. For example, a rating agency and a company's bondholders probably have similar needs for information about the company because the rating agency is evaluating the company on behalf of the bondholders.
2. Investors and creditors that can compel the delivery of information may offer insights into the types of information that may be useful to others but that are not currently part of mandated business reporting and should be considered for inclusion.

### For-Profit Entities

The Committee decided to limit the scope of its work to business reporting by business enterprises and has excluded from its consideration reporting by not-for-profit organizations and governmental entities. It limited its scope solely because of practical constraints on the time and resources available to complete the work. Business reporting by not-for-profit organizations and governmental entities is important. The Committee hopes its recommendations related to reporting by business enterprises will assist others in recommending improvements in the reporting by not-for-profit organizations and governmental entities.

### The Study

The Committee designed its study to meet key objectives and to mitigate certain risks inherent in the study. More specifically, the Committee designed the study to capture information that is representative of the needs of investors and creditors generally and to distinguish between needed information and less important
Representative Findings

If the information obtained from the study is biased or skewed, the risk is increased that resulting recommendations will not meet needs for information or that they will neglect important types of users. To help ensure that the information was representative, the study focused on direct input from users — documents written by users or based on research directly with them. The Committee ignored information it considered speculative.

The Committee is aware of a considerable body of research that provides important evidence about the effects of financial information and changes in that information on securities prices in capital markets. That research includes work on the efficiency of capital markets and accounting event studies. Although useful, those research results measure behavior and do not provide sufficient knowledge about users’ information needs for the Committee to use them to develop and support its recommendations.

To help ensure representative results, the study used multiple projects, each of which analyzed the information needs of users from a different perspective. Findings that recurred in several projects provided a level of confidence that a single perspective would not offer. Further, the study focused on information from groups of users rather than individuals. For example, the study found a number of surveys and documents from associations, such as the Robert Morris Associates (RMA), an association representing bank loan and credit officers. The Committee also sponsored a large random survey of users, seeking confirmation of their information needs and their reactions to its tentative recommendations.

Needed Information and Less Important Information

The study distinguished between the types of information that users need and the types that are interesting but not essential to their work. Users have insatiable appetites for information. Some of that information is essential to their work, other portions are helpful, and the remainder is interesting but rarely results in key decisions. Without the ability to evaluate the relative usefulness of information, resulting recommendations go too far, suggesting the need for information that does not improve the decision processes of users and thereby inflicting unnecessary costs on the reporting process.

To distinguish between needed information and nonessential information, the study used three techniques. First, the Committee developed a framework of information needs based on how investors value companies and how creditors assess the prospect of repayment. It considered information consistent with and central to the framework to be more important and other information less important. Second, the study sought data about the relative priority users place on different kinds of information, which helped the Committee rank potential improvements in business reporting. Third, the study sought data indicating the percentage of users that believe in one idea or another. Areas with the highest support suggested more important information.

Projects Undertaken

The study consisted of eight projects that together provided the basis for the Committee’s understanding of users’ needs for information:

1. Study and analysis of documents written by users or based on research directly with them about their needs for information.
2. Analysis of business and investment models.
3. Meetings with the Committee’s investor and creditor discussion groups.
4. Meetings with (a) the Financial Accounting Policy Committee of the Association of Investment Management and Research (AIMR), a group that represents portfolio managers and analysts, and (b) the RMA Accounting Policy Committee.
5. Meetings with other investors, creditors, and advisors.
6. Research sponsored by the Committee about the types of information included in analysts’ published reports about companies.
7. Research sponsored by the Committee about information supplied voluntarily to users in addition to
that required in business reports.

8. Survey of users about their information needs.

### Study and Analysis of Documents by Users or Based on Research Directly with Them

The Committee searched for books and articles that suggested improvements in business reporting and developed an electronic database with references to over 200 documents.

Unfortunately, the initial database was disappointing. It could not provide adequate information about the information needs of users because little of the material was written by users or based on research directly with them (direct documents). The recommendations usually were based on accounting theory or intuition rather than on specified users' needs. Relatively few of the articles referred to users, and those that did usually speculated about what would be helpful to users and did not develop recommendations based on direct research. As a result, the Committee undertook a second literature search that focused on direct documents.

The second search identified about twenty-five relevant direct documents. They included, for example, a study by SRI International of users' information needs and the annual report. SRI researchers based their study on personal interviews and focus groups, followed by a large telephone survey of users. The second set of documents also included letters from the RMA Accounting Policy Committee to standard setters, regulators, and the Committee on matters involving business reporting and included a survey by Hill and Knowlton, *The Annual Report: A Question of Credibility — A Survey of Individual and Professional Investors.*

Although helpful, the direct documents alone did not provide a sufficient basis for understanding users’ needs for information. Thus, the Committee supplemented them with additional projects that were either performed directly or sponsored by the Committee, as described below.

### Analysis of Business and Investment Models

The Committee studied business models to identify the changes affecting the business environment and to understand the key activities that create long term shareholder value in business enterprises. That study helped the Committee (1) develop a longer term perspective, (2) understand the types of information that would help users value companies, and (3) develop questions and information for later discussion with users. The Committee considered business models in several categories:

- Changes in the general environment affecting business, such as Alvin Toffler's *The Third Wave* and John Naisbitt's *Megatrends*.
- The impact of business environment on competitiveness, such as Michael Porter's *Competitive Advantage — Creating and Sustaining Superior Performance*.
- Business strategy, such as C.K. Prahalad's and Gary Hamel's paper "The Core Competence of the Corporation."
- Organizational design, such as Geary Rummler and Alan Brache's *Improving Performance — How to Manage the White Space on the Organization Chart*.
- Information for management decision making, such as Steven Hronec's book about performance measurement, *Vital Signs*, and Robert Eccles' article "The Performance Measurement Manifesto" and books about cost management, such as the *Handbook of Cost Management*, edited by Barry Brinker.

The Committee also studied investment models to understand how users value companies and assess the prospect of debt repayment. Those models helped the Committee understand the business valuation processes of users and provided direction and focus to recommendations about the nature of information that is useful in such processes. Those models also helped the Committee distinguish between users' needs for information and less important information. The Committee learned about those models from several sources, including *Graham and Dodd's Security Analysis*, by Sidney Cottle, Roger Murray, Frank Block, and Martin Leibowitz; *Creating Shareholder Value*, by Alfred Rappaport; *Valuation: Measuring and Managing the Value of Companies*, by Tom Copeland, Tim Koller, and Jack Murrin; *One Up on Wall Street*, by Peter Lynch; and *S&P's Corporate Finance Criteria*, by Standard & Poor's Corporation.
Meetings with the Committee's Investor and Creditor Discussion Groups

The Committee formed two groups of users for a series of formal, face-to-face meetings to answer questions and cover in more depth the issues about users’ information needs that had surfaced in its analysis of direct documents. It also wanted user reaction to its tentative conclusions about users' needs. The discussion groups also provided a means to meet other users for additional follow-up and in-depth discussions.

The groups included participants with diverse experiences and perspectives. The twelve members of the investor discussion group included portfolio managers and buy- and sell-side analysts with experience in a variety of industries. The fifteen members of the creditor discussion group included bankers from large and small institutions, debt security analysts, analysts from rating agencies, and an analyst involved in issuing performance bonds.

The Committee met with the investor discussion group on four occasions from October 1992 to March 1993 and with the creditor discussion group on three occasions from December 1992 to March 1993. Also, in April 1993, it met once with some participants from each group to discuss value information.

Each meeting lasted about four hours and followed the same format. Pre-meeting materials identified discussion questions and alternative responses to those questions. At the meetings, participants discussed their views on the questions and the reasons for those views. Following each meeting, the staff prepared transcripts and meeting summaries. Further, participants completed questionnaires that followed up in more depth on points raised during the meetings. The Committee's database, which is discussed below, includes both the meeting transcripts and responses to the post-meeting questionnaires.

Meetings with the AIMR Financial Accounting Policy Committee and the RMA Accounting Policy Committee

The Committee met with two groups that represent significant numbers of users: the AIMR Financial Accounting Policy Committee and the RMA Accounting Policy Committee. The purposes of those meetings were to determine whether their views were representative of the views of a wide range of the organizations' memberships; identify additional direct documents for analysis; and provide a means to meet other users for additional follow-up and in-depth discussions.

During the Committee's study, the AIMR committee was developing a position paper, Financial Reporting in the 1990's and Beyond, that summarized its views about external financial reporting. Major portions of the paper (which was circulated for comment, finalized, and published in 1993) are included in the database. The meeting with the AIMR committee also identified several more direct documents for consideration, including annual reports of the AIMR Corporate Information Committee, which rates the reporting practices of large public companies, portions of which also are in the database.

The RMA committee and the Committee discussed several technical matters that resulted in a subsequent exchange of correspondence, portions of which are included in the database.

Meetings with Other Investors, Creditors, and Advisors

Committee members and staff interviewed and observed the work of certain analysts, including sell-side analysts at two large brokerage and investment banking firms, and also met individually with buy-side analysts from investment management firms and a sell-side analyst who is well known in the European Community. Each meeting resulted in materials that summarized key points of the discussion, portions of which are included in the database.

Research Sponsored by the Committee About the Types of Information Included in Analysts' Published Reports
The Committee sponsored research to identify information important to analysts as evidenced by their analytical reports on specific companies. The research team analyzed 479 sell-side equity analyst reports included in a large automated database of published analysts’ reports about companies. The researchers read each report, categorized each type of commentary, and used content analysis software to develop an empirical profile of the reports.

The team also selected 1,000 debt-rating reports from the automated database and used content analysis software to develop an empirical profile of those reports.

The profile of the reports was used to identify key words and phrases which, in turn, allowed the researchers to draw inferences about the relative importance of specific elements of business information. Those inferences helped determine what information is more important to users and, to a lesser extent, how that information is used.

The research team summarized its findings and conclusions in A Content Analysis of Sell-Side Financial Analyst Company Reports, which is included in the database.

Research Sponsored by the Committee About Information Supplied Voluntarily to Users in Addition to That Required in Business Reports

The Committee commissioned research to identify and categorize the types of information companies supply voluntarily to users in addition to the information required in business reports to infer users’ information needs from that data. The researchers selected at random public companies and the Committee sought their participation in the study. Although the researchers had some difficulty in gaining access to information, particularly that not publicly available, they analyzed the data available and the report is included in the database.

The limited results of the research indicated that many public companies voluntarily supply to users the same types of information as found by the Committee’s study in other projects.

Survey of Users About Their Information Needs

A survey conducted by LH Research and directed by Louis Harris was designed to test the validity of the Committee’s tentative recommendations, which were based on the projects discussed above. The report, A Survey of Investors and Creditors About Their Information Needs, which is included in the database, was useful in validating the Committee’s tentative recommendations. The report also provided evidence in a small number of instances that was contrary to the tentative findings; this led, in some cases, to changes in the Committee’s tentative recommendations.

The survey was conducted by telephone after pilot testing and included approximately 1,200 users. About 60 percent of the participants were involved in investment decisions and the rest represented creditors. All participants responded to certain general questions and were divided into two approximately equal groups to respond to the remaining questions.

Areas for Further Study

The information resulting from the eight projects discussed above provided a reasonable basis for the Committee’s conclusions about the information needs of users. Thus, the Committee relied on those conclusions in developing recommendations to improve business reporting.

However, the Committee acknowledges that further study would provide important additional information to standard setters, regulators, and others charged with maintaining and improving the relevance of business reporting. The following examples illustrate the types of additional studies the Committee believes would provide useful information (studying the costs of providing information in business reporting also would be
helpful, as discussed in chapter 5):

- Study of empirical evidence about the correlation between information in business reporting and the cost of capital.
- Study of empirical evidence about the correlation between types of information in business reporting and the quality of decisions by users to determine both relevant information and less useful information that could be eliminated.
- Study of the types of information that companies voluntarily supply to users that are not required in business reporting.
- Study of the types of information that companies provide to users when seeking capital at critical stages, such as initial start-up, initial public offerings, responding to a hostile tender offer, major business combinations and reorganizations, and bankruptcy.
- Field-testing with users the Committee's recommendations to improve business reporting.
- Study of literature from non-U.S. authors related to the information needs of users in countries other than the U.S.
- Research about the information needs of users related to not-for-profit organizations and governmental entities.

**Analyzing the Data**

The Committee thoroughly analyzed the data from each project in the study. It first built a database of source materials about users' needs for information, which is organized by topic and includes extracts from direct documents, including transcripts from the investor and creditor discussion groups. The Committee next analyzed the material in the database topic by topic. Based on the source material, it identified leading views of users — those supported by a majority of users with well-reasoned arguments. It also identified issues on which users are divided. The Committee summarized its analysis in a document titled *Analysis of the Information Needs of Investors and Creditors*, which also is included in the database.

The Committee's database, described in appendix V, is available from the AICPA in both print and electronic form.

**Limitation**

An important limitation of the study is that it focused on immediate rather than longer term information needs. Most users naturally are concerned with current practice and their current problems. Thus, they seldom offer or consider radically new ways or processes by which better decisions could be made.

The Committee tried to bring a longer term perspective to its deliberations. To some degree, the study of business and investment models helped with a longer term view. In addition, the Committee sponsored a task force with the specific purpose of bringing a longer term focus to the study. To ensure a broad perspective, it included experts from various disciplines, including business strategy, management, economics, finance, accounting, and information technology — as well as a futurist. The task force contemplated the forces that will shape the global business environment in the longer term and the effects of those forces on the information needs of users of business reporting. The task force's report is included in the database.

The accelerating pace of change today coupled with the long lead time necessary to effect improvements in business reporting require standard setters and regulators to anticipate the changing needs of users. Without a long-term perspective, business reporting will continue to react to yesterday's crises and not keep pace with the evolving information needs of users.

**Conclusion**

The Committee's study of users' information needs has been unique and important. Not only has it provided a foundation for the Committee's work, but also the Committee hopes it will influence future agendas of standard setters and regulators and the direction of their projects. Most important, the study demonstrated the worth of focusing on users — the customers of business reporting — as a means to identify and evaluate ways to improve business reporting. Ongoing study is key to keeping pace with evolving needs for information.
This chapter discusses the information needs of users based on the Committee's study.

As discussed in chapter 2, the Committee's study, and therefore the following summary, applies to certain types of users — specifically, professional investors and creditors, and their advisors, that follow fundamental approaches and that cannot compel a company to produce the information needed for analysis.

Users' differ in their needs for information. A short-term trade creditor may need far less information than a long-term equity investor. The study sought to understand the extent of and reasons behind that diversity. The following discussion focuses on the information needs of users that have extensive needs for information and that look to business reporting as a major source for that information.

Predictably, the study indicated that users have a wide spectrum of opinion on many issues and insatiable appetites for information. When asked, users frequently say they want all possible information. Although that request is impractical, it reflects a willingness of users to wade through volumes of information to differentiate that which is useful from that which is not. As discussed in chapter 2, the study focused on views that are generally representative of users and it distinguished between information needs and less important information.

The following summarizes users' needs for information, not the Committee's recommendations to improve business reporting. Because of costs and other factors, business reporting cannot — and should not — meet all users' needs for information. Costs of business reporting are discussed in chapter 4, and the Committee's recommendations are discussed in subsequent chapters.

This chapter is divided into six sections: (1) objectives and approaches of users, (2) diversity of users' needs for information, (3) concepts underlying users' needs for information, (4) types of information that users need, (5) sources of information, and (6) qualitative aspects of information in business reporting.

**Objectives and Approaches of Users**

The objective of business reporting is to provide users with information that is helpful in deciding whether and at what price to commit, or continue to commit, resources to a particular company. The objectives and approaches differ depending on several factors, including whether users are evaluating equity securities (investors) or debt securities (creditors).

**Investors**

An investor's primary objective is to form opinions about the absolute and relative value of companies and their equity securities. In meeting that objective, investors use a variety of approaches to value companies and equity securities, including the following:

- Apply a multiple to the company's current or projected earnings, cash flows, or adjusted reported equity.
- Project the company's future cash flows and residual value and discount at a risk-adjusted cost of capital.
- Add to or subtract the estimated current or fair values of non-operating resources or obligations from the present value of future core earnings or cash flows.
- Total current or fair values of the company's major assets, and subtract the current or fair value of the company's debt.
- Identify recent favorable or unfavorable developments that are not yet reflected in the market price.
- Identify probable short-term price changes through indicators involving financial measurements, such as the momentum in the company's earnings.
The approaches may be performed individually or their results may be combined. They may be performed on a companywide basis or separately for individual segments.

Creditors

A creditor’s primary objective is to assess the ability of a company to meet its obligations related to current or future debt, or other financial instruments, through timely payment of principal and interest or, as a last resort, through transfer of a collateralized asset. In meeting that objective, creditors use a variety of approaches, including the following:

- Compare the company's current or projected earnings to current or projected fixed charges.
- Compare the company's current or future cash flows to current or future debt-service requirements.
- Assess the company's ability to raise cash from the sale of assets.
- Assess the company's ability to raise capital.
- Assess the company's ability to meet lending agreement covenants.

The approaches may be performed individually or their results may be combined. They may be performed on a companywide basis or separately for individual segments.

Diversity of Users’ Needs for Information

Users have diverse needs for information. The information an individual user needs depends on the approach followed, the instrument being evaluated, the company's various businesses and circumstances, and the user's personal preferences. The following discusses how those factors affect the information users need.

Approach

The approach used by users sometimes affects their needs for information. For example, contrast the information needs of investors that follow the earnings momentum approach as a means of predicting short-term stock price changes with those of investors that follow the fundamental approach as a means of determining the longer term value of a company's stock. Earnings momentum investors probably have extensive needs for information that helps predict near-term earnings and yet they probably need little information about the expected long-term impact of key trends. In contrast, investors following the fundamental approach probably are less concerned with near-term earnings but need far more information about the long-term impact of key trends.

Nature of Instrument

The nature of the financial instrument under analysis often affects users’ needs for information. For example, contrast the information needs of a bank credit officer who is evaluating a potential loan for an excellent credit risk and a bank trust department evaluating the same company's stock. If it is widely accepted that the company's cash flows are more than sufficient to pay its debts when due, then the credit officer may require no more information than the most recent audited financial statements and may use those statements only to verify certain key financial ratios. Further, the credit officer may need little information about risks if those risks are judged to be minimal in relation to the excess cash flows. Finally, the credit officer may need no information about the company's opportunities. In contrast, the trust department may need more extensive information. It may need sufficient information to forecast the company's earnings and detailed information about its opportunities and risks to judge the uncertainties of those earnings.

A Company's Circumstances

A company's businesses and circumstances can affect users' needs for information — for example, a company's circumstances can affect the extent to which investors need historical information. In most cases, historical financial and non-financial or operating business information over a ten-year period provides a foundation on which users can evaluate the future. However, for some companies, recent circumstances may
have changed so that historical information is not as helpful in predicting the future. Those situations are typical of start-up companies; cases in which changes in technology have redefined the market, product, or production process; and of companies emerging from dramatic restructuring, such as bankruptcy.

A company's circumstances also can affect the extent to which users need information about the value of certain assets. In many cases, the historical cost of assets provides useful information, and users have little need for fair value information. However, in some cases, the value of a company is based on the fair value of a few key assets or classes of assets. Examples include some natural resource companies for which the value of proved reserves or deposits determines a company's value. In those cases, users will need information that helps them value the key assets.

Users' Preferences

Another factor that affects users' needs for information is users' preferences. Two users may evaluate the same security, use the same approach, and yet have different needs for information because they assess facts differently, emphasize different matters, or have different time frames for their analyses.

Sources of Information

Even users with the same needs for information may have diverse needs for business reporting because of alternative sources for information. For example, users that have easy access to management may need less information from business reporting because they can satisfy their needs for certain information through discussions with management. In contrast, other users with little access to management may need more information from business reporting to satisfy their needs for company-specific information.

Concepts Underlying Users' Needs for Information

Regardless of the diversity just described, users, particularly those with extensive needs for company-specific information, share much in common in analyzing information in business reporting. The Committee's study identified seven concepts underlying users' needs for information, which are described below.

Analyze Separately Each Business Segment Having Diverse Opportunities and Risks

For users analyzing a company involved in diverse businesses, information about business segments often is as important as information about the company as a whole.

Segment reporting provides a proven and powerful tool to identify and analyze opportunities and risks that diverse companies face. Understanding opportunities and risks is key to determining whether to invest or extend credit and, if so, how to price that investment or credit. Further, for a diverse company, users find it more effective to project earnings or cash flows on a segment-by-segment basis than on the basis of the company as a whole. Also, when valuing companies, users often apply a different multiple or discount rate to a segment's earnings or cash flows, reflecting the diverse opportunities and risks of each segment. Segment data thus provide for a more refined valuation than otherwise would be possible.

There are many bases on which to segment a company's activities. They include industry, product lines, individual products, legal entities within a company, geographic based on where a company produces products or delivers services, geographic based on where a company sells its products or services, and others.

Depending on the circumstances, any of those bases could provide useful information. However, the study indicates that industry segment information most frequently provides the greatest insight into the opportunities and risks a company faces. Segmentation based on geographic location also provides insight, although it often is of less interest to users than is industry segment information. Some users, particularly creditors, prefer segmentation based on legal entities. (See exhibit 1.)
Industry Segments

Information about industry segments is particularly useful because industry structure is a key driver of opportunities and risks in nearly all businesses. Industry structure — the relationships among competitors in an industry, the bargaining power of suppliers and customers relative to other companies in the industry, the threat of new competitors and of substitute products or services — is a key determinant of future profitability and cash flows. Management, auditors, regulators, rating agencies, and users themselves frequently adopt an industry focus, in part because of the insight that focus brings in managing, auditing, or evaluating companies in an industry. For many users, the industry segment in a multisegment company is the unit of analysis — the unit users seek to understand in assessing the opportunities and risks a company faces.

Although they are comfortable with the concept of industry segments, users are troubled by its application in practice today. They believe many companies define industry segments too broadly for business reporting and thus report on too few industry segments. As a result, users say, they are unable to evaluate opportunities and risks at a sufficient level of detail.

Geographic Segments

Key trends (for example, political, sociological, regulatory, economic, and technological) vary widely from location to location. Thus, information based on the geographic areas where a company does business often provides important insight into a company's opportunities and risks resulting from those trends. For example, a company in a geographic region with a rapidly growing demand for its products is obviously in a better position than a competitor in regions where demand is not as favorable. Information about geographic segments can help distinguish between companies well positioned to take advantage of market opportunities and those that are not or those that are exposed to certain risks and those that are not, thereby providing important information about the opportunities and risks companies face.

Two categories of geographic information may be helpful in assessing opportunities and risks. The first is based on where a company sells its products or services (market locations). The second is based on where a company produces products or services (operating locations). Market locations affect the opportunities and risks for a company's revenues, and operating locations affect the opportunities and risks related to a company's costs. Both affect the opportunities and risks related to a company's assets. Although both perspectives may be useful, if forced to choose, users generally prefer information based on market locations because a company's success in the marketplace usually is the key driver of future earnings and cash flows.

The configuration and extent of geographic areas that companies should report vary depending on the company and its circumstances. For some, major areas of the world — such as the Americas, Europe, and
Asia — are the drivers of opportunities and risks. For others, individual countries, or regions within a country, provide the most insight. For example, the different economic conditions in various regions within the United States may be important to the operations of a real estate company with nationwide operations.

Although useful for many companies, geographic information may not provide much insight for some. For example, the technical performance of a new product may so dominate the opportunities and risks of a start-up company that geographic segment information may not add much value. As another example, a company may sell its products to a handful of customers that, in turn, use it in products they distribute around the world. In that case, geographic information based on where the company ships products to its customers may not be useful.

**Legal Entities**

Creditors often lend money to a particular legal entity within a consolidated group of companies. Thus, they have an interest in understanding the opportunities and risks of the particular legal entity and how its operations and financial affairs relate to those of other legal entities in the consolidated group. To meet their needs for information about legal entities, some creditors request financial statements by legal entity, in a consolidating format. Information about legal entities is less important or unimportant for users evaluating investments in a consolidated entity.

**Understand the Nature of a Company's Businesses**

All users following fundamental approaches of analysis need to understand the nature of a company's businesses, including the linkage between events and activities and the financial effect on a company of those events and activities. The nature of a business refers to the types of products or services offered, the methods of producing or delivering those products or services, the number and types of suppliers and customers, the locations of facilities and markets, and other factors that describe the activities of a business. Users cannot assess the risks and opportunities related to a company whose activities they do not understand.

Understanding the linkage between events and activities and the financial effect on a company of those events and activities is a critical part of understanding a business. Users recognize that financial results are a consequence of a company's business activities and events. Thus, users analyze and predict both business activities and events and the financial consequences of those activities and events. That process requires users to translate into financial terms their predictions of activities and events. That translation, in turn, requires that users also understand the linkage between activities and events and the financial effect of those activities and events.

**Obtain a Forward-Looking Perspective**

Users need a forward-looking perspective because their goal is to predict a company's financial future. But how do they obtain a forward-looking perspective? The study indicated that users use three methods:

1. *Study information about the past and the present.* The process of predicting the future usually begins with a study of the past and present. As discussed above, information about a company's businesses helps users identify opportunities and risks facing the company. Further, understanding the linkage between events and activities and the financial impact on a company of those events and activities often is necessary to forecast future financial performance. Information about the past is useful only to the extent it provides insight into the future.

2. *Search for leading indicators in historical data.* Leading indicators are existing conditions that provide insight into the future. Three examples are trends affecting the business, performance measures, and correlated measures.

Users often analyze historical data in searching for the impact of economic, technological, sociological, political, and regulatory trends that are expected to continue. It is very useful if data about a company are prepared in a fashion that facilitates the identification and analysis of trends. Two techniques are particularly helpful. First, the data should be prepared in a consistent fashion so that changes over time result from changes in activities and events and not from the way the data are prepared (consistency is discussed further in the section below, "Qualitative Aspects of Information in..."
Business Reporting," p. 32). Second, the effects of unusual and non-recurring activities and events should be segregated from the effects of recurring activities.

Performance measures are indicators of how well a company performs key business processes, such as a new product that wins awards for performance or quality.

Correlated measures are conditions closely correlated with a company's future performance. For example, housing starts may be a good leading indicator of revenues for companies producing building materials.

3. Search for forward-looking information. Forward-looking information is any prediction or information that aids prediction. It includes management's plans, assessments of opportunities and risks, and forecasted data.

Understand Management's Perspective

Users seek management's perspective about the businesses it manages for three reasons. First, management is closest to the businesses and therefore often the best source for company-specific information. Second, management influences a company's future direction. Thus, understanding management's vision for the company and its plans for the future provides users with a valuable leading indicator of where management will lead a company. Third, management's perspective provides users with valuable information to evaluate the quality of management, which also may be a leading indicator of the company's future performance.

Indicate the Relative Reliability of Information in Business Reporting

The usefulness of information is a function of its relevance and its reliability. Users obviously need information that is most relevant for their purposes. They also need information to be as reliable as possible. A large portion of relevant information also is reliable. For example, a company's contractual debt obligation usually can be reported reliably. However, other relevant information is inherently less reliable. For example, management may be very uncertain about its estimate of a liability for warranty claims.

Users need all information that is relevant for their purposes, including relevant information that is inherently less reliable. However, users also need to be able to distinguish between information that is highly reliable and that which is less reliable; that is, they need to understand the measurement uncertainty of less reliable information.

Understanding measurement uncertainty is important for at least two reasons. First, certain users may choose to reduce their reliance on information depending on the relative reliability of the information. Second, users consider information risk when valuing companies or evaluating credit risk.

The reliability of information is discussed further under "Qualitative Aspects of Information in Business Reporting."

Understand a Company's Performance Relative to That of Competitors and Other Companies

Users do not evaluate a company in a vacuum. Rather, they usually evaluate several companies at once. Users usually are deciding about which of a myriad of companies in which to invest — their investment options rarely are restricted to a single company. Further, comparing companies, particularly competitors, is useful in assessing relative strengths and weaknesses.

Comparing companies requires a basis for the comparison a yardstick against which to evaluate one company against others. Usually the basis for comparison involves measurements of various types. Examples include financial measures about assets, liabilities, equity, revenues, expenses, gains, losses, and cash flow. To be comparable, measures must be computed in the same fashion. For example, it is not useful to compare financial measures denominated in U.S. dollars to measures denominated in Japanese yen. Enabling the
comparison of information is a key reason for business reporting standards, which specify the types of measures to be reported and how they are computed.

Comparability is discussed further in the section below, "Qualitative Aspects of Information in Business Reporting."

**Understand Promptly Important Changes Affecting a Company**

One ingredient of relevant information is timeliness, which is important particularly for users of business reporting. Users need to understand promptly the important changes affecting a company. Important changes often affect users' decisions to commit or continue to commit capital to a company and, in extreme circumstances, may permit a user to effect change at a company in time to improve or protect the value of an investment. For example, an important positive development could cause a creditor to extend a loan commitment or to renew a commitment under more favorable terms to a company. Failure to understand promptly important changes increases the risk of mistakes in allocating and pricing capital.

Companies use business reporting as one vehicle to report important changes. Thus, the frequency of that reporting determines whether such changes are communicated promptly.

**Frequency of Reporting**

Many users seek new information about the economy, an industry, and a company and based on that information, update their views about a company's prospects on a regular basis. Quarterly reporting from the company is consistent with users' needs for updated information, with the exception of critical transactions and events, which should be reported within a few days of the transaction or event. Users believe more frequent reporting, such as monthly reporting, is not necessary because it is too short a period to discern trends or changes in trends. However, for many users, annual information from a company is not sufficient.

Quarterly reporting helps users identify, on a timely basis, trends and changes in trends affecting a company. Because users extrapolate trends, changes in users' perceptions about them often affect their judgments about a company's future. Thus, users need information about changes affecting a company shortly after those changes occur, without the significant lag that often would result from annual reporting alone.

Some believe, including some in management, that the importance of quarterly reporting is overemphasized. They believe that the securities market is too short-term oriented and quarterly reporting reinforces that short-term view. Thus, they suggest that quarterly reporting by public companies be abolished or, at a minimum, that improvements in quarterly reporting are unnecessary. They see little reason to accommodate the information needs of short-term users that serve only to increase the volatility of stock prices. They argue that annual reporting is sufficient for users with longer term views.

Users believe strongly that quarterly reporting by public companies should be retained. The Committee agrees with that belief for three reasons:

1. **Quarterly reporting helps users with a longer term focus.** Interest in recent developments is not inconsistent with a longer term view. It is critical that the user with a longer term focus detect, on a timely basis, changes in long-term trends. Quarterly reporting helps provide that information.

2. **Quarterly reporting provides for an orderly dissemination of reliable information.** Eliminating quarterly reporting will not cause short-term users to think longer term. They will continue to search for recent news about a company in the absence of quarterly reporting, although they will be more likely to trade based on rumor and less reliable information. Trading on rumor instead of information in quarterly reporting may increase — not reduce — volatility in securities markets.

3. **Quarterly reporting reduces problems of trading on inside information.** The securities laws prohibit trading on inside information. Quarterly reporting provides a vehicle for companies to disseminate information so market participants have equal access to reliable information about a company on which to trade freely.

Quarterly reporting by public companies has been accepted for many years. Further, many private companies report on an interim basis at the request of users. However, interim reporting is not needed by all users. For
example, a trade creditor of a well-established, profitable company may be comfortable with annual reporting by its customer. Users often do not need to have all private companies report quarterly; the need for interim reporting varies for private companies.

Types of Information That Users Need

The study identified the types of information that users need, focusing on the information needs of users with extensive needs for information. The types of information are limited to what can be provided by business reporting. More specifically, they are limited to company-specific information for which management is often the best source.

Users need company-specific information in five categories, which are consistent with the concepts underlying users’ needs for information discussed above:

1. Financial and non-financial data.
3. Forward-looking information.
4. Information about management and shareholders.
5. Background about a company.

The following section discusses the types of information in each category and how that information helps users meet their objectives.

Financial and Non-Financial Data

The data in this category are of two types: (1) financial statements and related disclosures and (2) high-level operating data and performance measurements that management uses to manage the business. Each type is discussed below.

Financial Statements and Related Disclosures

Financial statements are the center of business reporting. They represent the financial picture of a company, both at a point in time and over a period of time, translating into financial terms many, but not all, of the events and activities that affect it. Investors use financial statements for various purposes, such as an analytical tool, a management report card, an early warning device, a statement of collateral or security interest, and a device for control and accountability. Many investment decisions — such as whether to lend money; whether to buy, hold, or sell securities; and how to price transactions — are based, in large part, on the information in financial statements.

The Committee's study confirmed the importance of financial statements. Financial statements generally provide users with essential information that heavily influences their decisions. There is no evidence that users are abandoning analyses of financial statements because they believe the information is irrelevant or for other reasons.

The study indicated that financial statements are an excellent model for capturing and organizing financial information. They package information in a structured fashion that permits analysis of a wide range of trends and relationships among the data. These trends and relationships, in turn, provide considerable insight into a company's opportunities and risks, including growth and market acceptance, costs, productivity, profitability, liquidity, collateral, and many others. No user suggested that financial statements should be scrapped and replaced with a fundamentally different means of organizing financial information.

Financial statements also are popular because they are adaptable to the diverse information needs of various users. As discussed above, users differ in their sophistication, the types of securities they analyze, the objectives and approaches to their work, and their personal preferences in performing their duties. As a result of those differences, users focus on different types of financial data as well as trends and relationships among that data. Fortunately, financial statements provide a broad array of financial information that allows many
users to focus on the particular trends and relationships they find most useful.

Financial statements assist with five of the key concepts underlying users' needs for information discussed in the previous section. Disclosure of segment financial data helps users analyze separately a company's business segments. Financial statements also help users understand the nature of a company's business by indicating the types of its assets, the need for working capital, the types of its revenues, the general nature of its expenses, the sources and uses of its cash flows, and other aspects of its business. Financial statements help users understand the linkage between business activities and events and the financial effects of those events. For example, analysis of financial statements over time can help users understand the relationship between cost, volume, and profit. Further, analysis of financial statements can help users obtain a forward-looking perspective by, for example, surfacing trends affecting the business. Because financial statements are comparable among companies, they help users understand performance relative to that of competitors and other companies. Finally, financial statements can help communicate important changes affecting a company.

Despite the general vote of confidence, however, users were strongly critical of certain aspects of financial reporting, and they offered or supported many substantive ideas for its improvement. Understanding the reasons for the criticism has been instructive as it helped the Committee identify high-priority issues and develop recommendations. Users' views and the Committee's recommendations related to financial statements are discussed in chapter 6.

**High-Level Operating Data and Performance Measurements**

Operating data are statistics about a company's business activities, excluding data reported in financial statements and related disclosures, which the Committee considers to be financial data. Operating data may be denominated in terms of a currency or in terms of units of product or service, number of employees, units of time, and others.

Performance measurements are data about a company's key business processes. For example, they relate to the quality of products or services, the relative cost of activities, and the time required to perform key activities, such as new product development. The distinction between operating data and performance measurements is unimportant and some measures may fall in both categories. For example, productivity measures, such as the ratio of outputs to inputs, are both an operating statistic and a performance measure.

Although the results of users' analyses often are expressed in financial terms, such as the value of a security or the amount of cash flow available for debt service, users' analyses rarely are confined to financial measures. Many users will model company revenues and costs both in operating terms — such as units sold, key resources consumed, and number of employees — and financial terms — such as revenues, cost of revenues, and operating profit. The practice of modeling both business activities and financial results helps users understand, for example, the relationship between cost, volume, and profit. It also helps users answer questions such as: What would profit be if unit volume declined 10 percent? What will happen to profits if a company restructures and terminates 10 percent of its workforce?

The Committee's discussions with users and study of analysts' reports provided many examples of forecasts based on both financial and operating terms. To illustrate a common example, assume a user wishes to predict a widget company's revenues over the next few years. One method is to extrapolate the trend in historical revenues from the company's financial statements. A second method is to predict future revenues based on estimates of the number of widgets the company may sell and the widgets' future selling price. The number of widgets could be predicted, for example, based on industry estimates of the total market for widgets and the user's estimate of the company's share of that market. The market share could be based on recent trends in that share and the user's judgment about the quality of the company's widget compared to that of competitors. The user could estimate future price based on recent trends in that price and estimates about whether the widget industry would be operating at or near capacity in future years.

In practice, users are likely to use both methods to predict future revenues and to compare the results of the two. The first method requires only historical financial statements. In contrast, the second method requires a variety of information, none of which comes from financial statements, and also that users understand and predict the linkage between number of widgets sold and future revenues — in this case, the future selling price for a widget.
The Committee’s study indicated users are as interested in a company’s business activities, business processes, and events affecting a company as they are in financial measures about a company. The Committee’s study of analysts’ reports indicated analysts write as extensively about business activities and events affecting a company as they do about financial results or predictions. For example, they frequently write about the trends in units sold and selling prices, the number of employees, trends in wages, and trends in costs of purchased materials. The study of materials voluntarily supplied by companies indicated that many large public companies supply users with "fact books" containing data about a company’s business activities and processes. The Committee also found users as likely to discuss business activities and processes as financial performance.

The users' goal may be to project a company's financial future, but that goal requires information about a company's activities, processes, and events that affect it and the translation of those activities and events into financial terms. Users do not rely on financial results alone (see exhibit 2, p. 28).

Companies manage their businesses using a myriad of operating data and performance measures, much of which relate to detailed and specific operations, such as that of a single machine, production line, or even an operating location. What users find useful, however, is high-level operating data and performance measures relating to the business segment level of operations.

High-level operating data and performance measures help with five of the key concepts underlying users’ needs for information. Operating data and performance measures that relate to the business segment level help users analyze separately a company's business segments. They also help users understand the nature of a company's businesses. In particular, operating data and performance measures are useful in helping users understand the linkage between events and activities and the financial impact of those events on a company. They also may help users identify trends affecting a business and thereby provide users with a forward-looking perspective. Further, operating data and performance measures can help users understand management's perspective by noting the types of data that management is using to manage the business.

**Management's Analysis of Financial and Non-Financial Data**

Users find management's analysis is important to understand the business reasons for changes in data about a company. Management is closest to the business and often has analyzed data about its company for purposes of managing the business. Thus, management is often the best source for analytical information.

Management's analysis includes two elements. The first includes reasons for changes in the financial, operating, and performance-related data. Users want to know about changes relating to market acceptance, productivity, costs of key resources, profitability, innovation, changes in financial position, liquidity, and the
identity and effect of unusual or non-recurring transactions and events. The second category identifies key
trends and discusses the past effect of those trends.

Management's analysis is consistent with several of the concepts underlying users’ needs for information
discussed in the previous section. Management's analysis of each business segment helps users analyze a
compny's business segments separately. The analysis also helps users understand a company's business
and, in particular, the linkage between events and activities and the financial impact of those events and
activities. Further, it helps users with a forward-looking perspective by identifying and discussing the past effect
of trends and performance measures — both useful leading indicators of future performance. Finally, it helps
users understand management's perspective.

Public company disclosures include management's discussion and analysis of financial condition and results of
operations (MD&A). Current MD&A disclosures focus on explaining changes in amounts in financial
statements. In contrast, users would find helpful an expanded analysis that includes analysis of changes in
operating data and performance measures as well as changes in amounts in financial statements.

Although users have found practice under current requirements to be useful, they are critical of current practice
for the following reasons:

• **Superficial analysis.** Users complain that MD&A too often identifies only changes that are evident
  from the face of the financial statements without providing information about the business reasons for
  changes and trends. In general, they criticize MD&A for not providing sufficient insight.

• **One-sided analysis.** Users believe that MD&A focuses too much on positive events. They would
  prefer more balanced reporting that discusses both positive and negative developments and the
  reasons for those developments.

• **Confusing and incomplete comments about business segments.** Business segments mentioned in
  MD&A, if any, often are different from the business segments reported in the segment note in the
  financial statements. Users would prefer the business segments discussed in MD&A to be consistent
  with the business segments identified in the financial statements. Further, many multisection
  companies provide only incomplete analysis of business segment data or do not separately address
  their business segments in MD&A.

In addition to explaining changes in financial data, MD&A requires management to provide a forward-looking
perspective by discussing events and uncertainties that would cause reported financial information not to be
indicative of future operating results or financial condition. Users' interest in forward-looking information is
discussed in the following section.

**Forward-Looking Information**

The study found that users find useful management's perspective on two types of forward-looking information.
The first is about opportunities and risks and the second is about management's plans for the future. Although
users are interested in forecasted financial and operating data, they generally believe that management should
not include those forecasts in business reporting.

**Opportunities and Risks**

Opportunities and risks result from changes in a company's industry conditions, such as a threat from
substitute products or services, changes in the bargaining power of customers or suppliers, including
employees, and changes in the nature of competition with competitors. Opportunities and risks also result from
concentrations in a company's assets, customers, or suppliers. Users also are concerned about illiquidity risks
and contingent gains and losses related to a company's rights and obligations.

Understanding the opportunities and risks a company faces is critical to users and is common to most of their
analytical approaches. Assessments about opportunities and risks directly affect a users' valuation of a
company or judgments about credit risk. For example, information about opportunities and risks determines the
multiple or discount rate that investors use in valuing companies.
Users learn about and assess opportunities and risks from many sources of information, including industry and trade publications, financial statements, operating data, discussions with other users, and others. However, information from a company's management is particularly useful. Management often is an excellent source for information about opportunities and risks because it is closest to the business and usually has considered opportunities and risks in planning for the future and managing the business. Also, understanding what management thinks about opportunities and risks helps users understand where management plans to lead a company.

**Management's Plans, Including Critical Success Factors**

Understanding management's plans is important for users. Management is the best source of information about the direction it intends to lead the company and its plans are an important leading indicator of the company's future. Even though a company may not achieve its plans, understanding the general direction of the company is helpful. Also, management's plans are an important driver of the opportunities and risks a company will face.

Plans usually depend on key assumptions about factors or conditions that must be present for the plans to be successful (critical success factors). For example, a computer maker's plan to be first to market with innovative and technologically superior products may be based on an assumption that key suppliers will continue to work with the company to incorporate leading technology into its products. If suppliers choose to treat all computer makers equally, then the company's plan will fail. Users find information about critical success factors useful because they provide insights about the opportunities and risks a company faces.

**Forecasted Operating and Financial Data**

The approaches used by many users to value companies or assess credit risks require forecasted data, particularly financial data. Usually, those forecasted data are the results of considerable work by the forecaster after analyzing the types of information discussed in this chapter. Despite the relevance of forecasted data, except in the circumstances described below, users generally do not need forecasted data from management in business reporting, for the following reasons:

- Users generally prefer to make their own forecasts. Many users consider themselves experts in forecasting, valuing companies, or assessing credit risk and consider forecasting as an integral part of their role. Further, users believe they are more objective.
- Point estimates of future financial performance are inherently imprecise. Further, users' experience with those forecasts leads them to believe that management forecasts tend to be overly optimistic.
- Forecasts would increase litigation against the company. Forecasts that, with the benefit of hindsight, failed to foretell the future accurately would be easy targets for lawsuits filed routinely against companies whose stock prices have fallen.

Although users generally do not need forecasted data from management, some users, particularly lenders to smaller companies, seek management's forecast, for the following reasons:

- A forecast helps the user understand management's view of the future and its plans for the company.
- Preparing forecasted data disciplines management to develop plans and think through the financial implications of those plans, an exercise that benefits both management and reduces credit risk for the lender.

**Information About Management and Shareholders**

Users of public company reports emphasized the importance to their analysis of information in annual proxy statements furnished to shareholders. More specifically, they find information in the following categories useful:

- The identity and background of directors and executive management.
- The types and amount of executive management compensation, the methods or formulas used in computing that compensation, and the number of shares owned by senior management.
• Matters about security ownership, such as the identity and ownership of major owners and the nature of existing arrangements that result in a change in control.
• Related-party transactions and relationships among major shareholders, directors, management, suppliers, customers, competitors, and the company.

**Background About a Company**

Users also need background information about a company which provides users with a mental image of a company's businesses — the business engines that generate cash flows and earnings. Users need the information for each business segment. More specifically, users find background information useful in the following categories, for the reasons indicated:

• *Broad objectives and strategy* — help users understand the broad goals of a business and the general strategies that management is using to achieve those goals. This information, in turn, provides a forward-looking perspective about where management intends to lead a company.
• *Scope and description of business and properties* — help users understand the scope and nature of a company's businesses, which are the foundation of information on which users' analysis of a company is based.
• *Impact of industry structure on a company* — helps users evaluate opportunities and risks. It addresses new products or services that are affecting the market served by a business, the bargaining power of suppliers and customers, and the intensity of competition facing a business.

**Sources of Information**

Users need and use information from multiple sources for two reasons. First, users need information from the best sources, which differ depending on the type of information and other factors. For example, users obtain information about the economy from economic studies and reports by economists and other sources. They obtain information about industry conditions from industry trade publications, government statistics, and others. Although a company's management is often the best source for a large portion of company-specific information, it is not the only source, nor always the best source. For example, users learn about a company's stock price and trading volume from a stock exchange.

Second, obtaining the same type of information from multiple sources allows users to compare views and assess the relative reliability of the information. For example, users may learn about a company's strengths and weaknesses from its management, competitors, customers, and other users, each of which may offer a different perspective. Users can judge for themselves about which view is the most reliable.

Despite its usefulness, users do not want business reporting to become the only source for their information.

**Databases**

Users are increasingly using databases and will continue to use them mostly for screening purposes and to gain rapid access to aggregate industry information. Databases are useful to users because they provide easy access to considerable financial information for a large number of companies. However, their use is restricted mostly to screening purposes and to accessing aggregate information because (1) the information is not timely; (2) the information is not comprehensive (for example, notes to the financial statements normally are not included in the databases, which makes it more difficult to identify differences in accounting practices among companies); and (3) adjustments are made in the databases that are not easily identifiable and understandable.

Users are willing to use databases in the future to assist them with their analytical work on specific companies as the information provided in databases becomes more comprehensive, consistent, reliable, and comparable. Some believe that further advances on database technology (for example, the SEC's EDGAR system), combined with improvements in financial reporting practices, inevitably will lead to an increase in the uses of databases.
Qualitative Aspects of Information in Business Reporting

Users are deeply concerned about the relevance, reliability, and comparability of information — the qualitative aspects of business reporting. Most of the Committee's study of users concerned the relevance of information. The Committee identified the types of information that users find most relevant and the appropriate timeliness of that information, which are discussed elsewhere in this chapter. This section discusses the remaining issues of reliability and comparability of information.

Reliability

The reliability of information depends on the faithfulness with which information represents what it purports to represent. It also depends on the degree to which information is verifiable.

Users are very concerned about the reliability of information in business reporting. They believe that many companies' managements are not forthright in reporting problems and poor company performance, that much of the information they disseminate is too promotional, and that troubled companies take great pains to convey the impression that they are not seriously troubled. Although they have confidence in management integrity, users say managers commonly procrastinate about disclosing problems and many managers express a more optimistic view of their companies' situations than seems warranted by the users' own analyses. Users believe, for example, that management emphasizes non-recurring losses while burying non-recurring gains in continuing earnings. They also believe that management tends to double up when reporting bad news by also recognizing other losses that have occurred earlier but whose recognition has been deferred or losses whose current recognition will avoid the need to recognize expenses or losses in the future.

The confidence of the user community is shaken by a series of surprise adjustments or writeoffs. Those events seem to occur in periods of economic stress. Frequent write-downs of assets and recurring restructuring charges have led users to believe that companies' asset amounts have been overstated in the past, resulting in loss of confidence in the accuracy and reliability of amounts that are reported currently.

Users need audited financial information because it provides independent assurance of the reliability of amounts reported and disclosed in financial statements that are not otherwise verifiable by third-party users. In their analyses, most users rely heavily on information that has been verified by auditors independent of management. Auditor involvement in financial reporting provides a discipline for management to adhere to established requirements.

Most users would be unwilling to lose the comfort of an independent audit function. Independence gives users assurance that confirmation and verification procedures have been performed by those not subject to management influence.

Neutrality

Neutrality means that in formulating and implementing standards, the primary concern should be the relevance and reliability of information, not the effect the new standard may have on a particular interest.

Users wholeheartedly support the precept that standards setters ensure, insofar as possible, the neutrality of information. Any other approach would undermine the usefulness of information in business reporting. Users believe that business reporting should help users in making rational investment, credit, and similar decisions but should not try to determine or influence the outcomes of those decisions. The role of business reporting requires it to provide evenhanded, neutral, and unbiased information.

Role of Conservatism

For users, conservatism in reporting means the uncertainties that are inherent in many transactions should be recognized by exercising prudence in reporting. Conservatism should mean prudence in evaluating uncertain outcomes and amounts, not the creation of arbitrary reserves. Another widely expressed view is that conservatism makes it likely that possible errors in measurement will be in the direction of understatement rather than overstatement of net income and net assets. Thus, future surprises likely will be pleasant. In both
views users emphasize prudence, but reject the notion of deliberate understatement of assets, overstatement of liabilities, or smoothing of income.

**Volatility**

Users believe businesses that are volatile should report that volatility faithfully and should not smooth earnings to appear less volatile than the underlying business. Some preparers believe stable results tend to lower the cost of capital. Users need to be apprised of the true volatility to make correct judgments in allocating capital. Companies that report significant swings in earnings are more difficult to analyze. However, if that is the nature of their business or industry and, therefore, a risk that needs to be understood, a user needs to understand that fact.

**Comparability**

Analysis for both investment and credit decisions relies on three types of comparisons:

1. *Interfirm comparability*, which allows comparison between and among different companies (cross-sectional analysis).
2. *Interperiod consistency*, which allows comparison of data from one reporting period to the next for a single company (time series analysis).
3. *Internal consistency*, which allows comparison of one financial statement item to another (financial ratio analysis).

Comparability and consistency in financial reporting over a long time, generally five to ten years, is very important to users in comparing a company’s performance and financial position within its industry and across industry lines, and in identifying trends.

Many users believe they can handle differences in accounting among companies, even in the same business, if they can obtain information that enables them to understand the differences and interpret them as clearly as possible. Differences in the way companies apply accounting rules should be allowed as long as there is disclosure of the application methods.

Many users value information that is consistent over time more highly than information that is comparable among companies because they consider themselves capable of adjusting information to compensate for non-comparabilities resulting from use of alternative accounting procedures and the many differences in companies. However, they usually are unable to adjust for inconsistent information resulting from business combinations accounted for by the purchase method, changes in accounting principles, and the like.

**Accounting Standards and Comparability**

A change in accounting principles destroys the interperiod consistency of data before and after the change. Even if standards setters require restatement of prior-period data, public companies provide only three comparable income statements and two comparable balance sheets. Users sometimes have sufficient information to estimate the effect of the change on earlier years and are able to restate the results themselves, and some companies take the time to assist users in understanding the pre- and post-change data. Generally, however, the ability to analyze trends over a long period is destroyed. New accounting standards that do not preserve the consistency of information result in significant costs for users.

Effective date and transition provisions that permit a new reporting standard to be adopted in any of several years and that allow a choice of how to adopt, such as retroactive application, prospective application, and the like, are particularly troublesome for users.

Users do not suggest that standard setters issue fewer standards. However, they suggest that standard setters should simplify the procedure for adopting new pronouncements by making them effective for everyone in a single year and prescribing only one method of adoption.
In addition to the general understanding of users' needs for information discussed in this chapter, the Committee's study considered users' needs for information in more specific areas, many related to financial statements. Chapter 6 includes information about users' needs for information in the following categories:

- Display of information in financial statements.
- Unusual or non-recurring transactions or events.
- Disclosures related to unconsolidated entities.
- Accounting for intangibles, including goodwill.
- Measurement uncertainties.
- Reporting financial information by segment.
- Purchase and pooling methods of accounting for business combinations.
- Limiting the range of accounting alternatives.
- Off-balance-sheet financing arrangements.
- Accounting for leases and other executory contracts.
- Accounting and disclosures for innovative financial instruments.
- Value information in financial statements.

In addition to the above, user views on auditor association with business reporting are discussed in chapter 7 and user views on international harmonization of accounting standards are summarized in chapter 8.
Chapter 4 — Benefits and Costs

The Committee's approach to the benefits and costs of disclosure included three key procedures: identifying the benefits and costs of decision-useful information, identifying types of information that could provide significant benefits to business report users, and developing criteria that limit costs in cases in which costs could be significant.

This approach, described in more detail below, is consistent with the long-acknowledged constraints on cost-benefit analysis for disclosure. There is no accepted technique of quantifying such benefits and costs. But benefits and costs nevertheless have been considered regularly by standard setters, such as the Financial Accounting Standards Board (FASB), by regulators of corporate disclosure, such as the SEC, and by other groups considering disclosure. For example, the Advisory Committee on Corporate Disclosure, a distinguished body that reported to the SEC in 1977, frankly stated that though its charge included analyzing benefits and costs, it had been "generally unable" to reduce them to "objectively measurable terms." Similarly, the FASB, which regularly considers the benefits and costs of its standards, says in its conceptual framework, "the benefits from financial information are usually difficult or impossible to measure objectively, and the costs often are; different persons will honestly disagree about whether the benefits of the information justify its costs."

This chapter presents the main findings from the Committee's study of the benefits and costs of disclosure and explains how the Committee applied its approach to benefits and costs.

Analysis of Generic Benefits and Costs

The Committee's analysis of the generic benefits and costs of informative disclosure was partly an exercise in studying long-known benefits and costs. However, the Committee also tried both to identify the full range of generic benefits and costs and to pursue their ramifications and interrelationships.

The analysis focused only on informative disclosure. The term means information useful for decision making even if it involves costs that outweigh its usefulness. Informative disclosure is reliable; it is unbiased and untarnished by misleading omissions. Its usefulness, still by definition, is explicit: It provides an opportunity for a decision maker to obtain an incremental improvement in assessing the real prospects of a company.

Allocating and Pricing Capital

Increased informative disclosure benefits users by reducing the likelihood that they will misallocate their capital. This is obviously a direct benefit to individual users of business reports. The disclosure reduces the risk of misallocation by enabling users to improve their assessments of a company's prospects. Although this is built into the definition of informative disclosure, it is far from a mere abstraction. It is a solid benefit long appreciated in the financial reporting community. The benefit and the process that creates it have three important ramifications.

The first is the effect on the allocation of capital countrywide and its meaning for the economy. Users that use informative disclosure to increase the likelihood and dimensions of their investment returns simultaneously are seeking out and supporting the most productive companies, the companies that can contribute most to economic growth and national competitiveness. Conversely, unwise investments are bad for economic growth and national competitiveness. Thus, an important benefit of informative disclosure is that it improves the effectiveness of the allocation of capital. This is a benefit to society as a whole.

The public interest in effective allocation of capital cannot be underestimated. It has been of concern in recent years, both because of intensified international competition and the social need to increase job formation. The concern is visible in debates over "industrial policy" and in studies on building national competitiveness.

The second ramification lies in the effect of the process of providing users with informative disclosure on the liquidity of the capital markets. A more liquid market assists the effective allocation of capital by allowing users to reallocate their capital quickly. It thereby contributes to the same set of benefits. Liquidity varies according to
the bid-ask spread. The wider the bid-ask spread, the less liquidity (that is, fewer transactions take place), and
the narrower the bid-ask spread, the greater the liquidity (that is, more transactions take place). Two principal
determinants of the bid-ask spread are the degree of information asymmetry between the buyer and seller
and the degree of uncertainty of the buyer and the seller. Both larger asymmetry and greater uncertainty widen
the spread, but lower asymmetry and less uncertainty — two products of broad, public disclosure — diminish it,
thereby increasing liquidity.

The third ramification of users' improved capital-allocation decisions is their effect on the disclosing entity's cost
of capital. The benefits to users are translated into lower capital prices, a benefit for companies. This takes
place across the total population of disclosing companies and is therefore a reduction in the average
company's cost of capital. As the word average suggests, the benefit does not mean that every company in
every situation benefits by a lower cost of capital from increased informative disclosure. The benefit must be
put in perspective.

Looking at the process conceptually, informative disclosure helps users understand the economic risk of a
prospective investment. Without any information, the user has no way of assessing a company's prospects.
Capital is unlikely to be advanced under such circumstances, but if it is, it will be at some very high price. Now
consider the opposite extreme, the ideal state of total informative disclosure. In this situation, the user has all
the knowledge necessary to assess a company's prospects. The price of capital therefore would be based on a
company's economic risks (as assessed with the informative disclosure) and the risk-free rate of return (in our
society this is generally considered the rate on Treasury bills). Between the two extremes is the real world,
where informative disclosure helps investors interpret companies' economic prospects and the interpretations
result on average in a lower price for capital.

This scenario appears to run counter to the well-known situation of a company that discloses bad news and
has its cost of capital rise. However, there is no contradiction when it is remembered that the scenario applies
only to the average company — that is, across the whole population of capital transactions — and when two
additional factors are considered. First, information about a company can give either positive or negative
impressions of its prospects, and the combination of such types of information contributes to learning the
economic risk of the business. Thus, when the information indicates poor prospects, it means that the entity's
economic risk is high, not that the increment in information is functioning to raise the price of capital. Getting a
better understanding of the true economic risk would still lower the price of capital for the average company.
Second, overoptimistic misinterpretations of a company's economic prospects, which would lead additional
informative disclosure to correct the misinterpretation and result in a higher price for capital, should be
balanced by overpessimistic misinterpretations. It is reasonable to assume that misinterpretations distribute
normally between under- and overestimates of companies' economic prospects, with the net result for all
companies that informative disclosure reduces the average cost of capital.

It is difficult to prove empirically that the average cost of capital is lowered by informative disclosure, even
though it is logically and practically impossible to assess a company's economic risk without relevant
information. There is abundant evidence that prices are influenced by disclosure (efficient markets research).
We also know that capital suppliers request and sometimes demand disclosures that is, they sometimes make
disclosure a condition of the transaction. We also have anecdotal evidence, such as the article by Paul
Sweeney in the New York Times arguing that many companies "realize that institutional investors prefer to put
money into companies that provide lots of information and that good investor relations can help their stock
price." These kinds of evidence are suggestive but are not an empirical case that informative disclosure
lowers the cost of capital.

Apart from the fact that the disclosure selected for testing must indeed be informative, practical problems have
presented obstacles to empirical study. There are, however, two such studies. Dan S. Dhaliwal's study of line
of business reporting produced findings consistent with the lower-cost-of-capital thesis. More recently, Teresa
L. Conover and Wanda A. Wallace found that greater extent of disaggregated disclosure for geographical
segments correlated with higher stock prices.

To the degree that additional informative disclosure in fact leads to lower capital costs, it benefits society as a
whole. Lower capital costs promote investment, which, assuming wise investment, stimulates productivity and
economic growth.

Consumer Protection
One other benefit must be noted before moving on to costs — the public benefit of consumer protection. To the degree that informative disclosure provides needed consumer protection to users, other things being equal, the public benefits. The benefit is fairness to consumers, even though the confidence such fairness promotes is also good for the economy and is part of corporate accountability to society as a whole. One of the purposes of the SEC’s mandate and the statutory disclosure system it regulates is consumer protection. The longevity of this system, now three generations old, suggests that our society values its consumer-protection benefit highly.

**Company Costs**

There are three primary company costs: (1) the cost of developing and disseminating information, (2) the cost of litigation attributable to informative disclosure, and (3) the cost of competitive disadvantage attributable to disclosure. As described in the next section, the Committee developed cost-limiting criteria for all three of these.

*Developing and Disseminating Information*

The costs of working up and delivering disclosure include the cost of gathering, processing, auditing (if the information is audited), and disseminating the information. These costs also include what is incurred to work up and deliver responses to questions about already issued disclosure. Owners alone ultimately pay all these costs, just as they ultimately bear all company costs.

The cost of developing and presenting information that is also used or needed by management must be excluded from the cost of developing such information for external disclosure. To the degree that the work has been done already or would be done for managerial purposes, there would be no need to duplicate it. Other disclosure costs (formatting, packaging, auditing, and disseminating information), however, would be unaffected by the overlap between costs incurred for managerial purposes and costs incurred for purposes of external disclosure.

Potential owners obtain the benefits of disclosure without the costs. However, they would pay if they became owners in the sense that the stream of cash flows to the company would be curtailed by the cost of the disclosure the potential owner had used as a free rider.

*Litigation*

Although litigation costs are known to arise from informative disclosure, it does not follow that all informative disclosure leads to litigation costs. Therefore, in order to assess the relationship between informative disclosure and litigation costs, cases exclusively attributable to informative disclosure must be distinguished from other cases involving disclosure.

The first distinction is between cases that arise from allegations of insufficient disclosure and those arising from allegations of misleading disclosure. Only the latter are prompted by the presentation of informative disclosure.

The second distinction is between cases of genuinely misleading disclosure and cases where the accusation of misleading disclosure is false. Genuinely misleading disclosure is not informative disclosure as we have defined it, because informative disclosure is unbiased and helpful to users. Such suits are similar to those arising from allegations of insufficient disclosure in that informative disclosure is both not at issue and, if presented, might have prevented the suit. Suits whose accusation of misleading disclosure is false are meritless and should never have been brought, but informative disclosure is indubitably their subject.

The third distinction is within the population of meritless suits. A much-discussed characteristic of many meritless suits is that a drop in stock price triggers the suit. In these situations, informative disclosure is a cause of the suit but not the primary cause. The same disclosure without stock-price volatility presumably would not have led to litigation, and the stock-price volatility alone, in the absence of that particular disclosure, presumably would have been sufficient to cause the litigation.

In two of the categories above, informative disclosure would prevent or might have prevented the suit (allegations of insufficient and of misleading disclosure). Thus, the population of suits that add costs
attributable to informative disclosure is only meritless suits.

Meritless suits have been widely denounced. They have been cited in congressional hearings, and legislation has been introduced in Congress with provisions to reduce their frequency. The costs of such suits can be very significant. Apart from the legal fees, court awards, and the costs of settlements made strictly as business decisions (the lesser of two cost evils), there is a cost in public relations and in the distraction of executives from productive activities in a company's interests. Although these are not regular costs for all companies, directors' and officers' insurance is a widespread cost that is arguably attributable in significant measure to meritless suits.

Litigation costs are a drag on sued companies and on the economy as a whole. Nevertheless, it is difficult to reach a conclusion on the overall effects of informative disclosure on litigation costs. The whole population of suits must be considered, including those in which informative disclosure could have prevented certain types of suits (allegations of insufficient and of misleading disclosure) and those where price volatility appeared to be the primary cause. In addition, the whole population of disclosure events must be considered, not just those that lead to suits, and within that population, suits alleging fraudulent disclosure are a tiny minority, dwarfed by events of genuinely informative disclosure. Voluntary disclosures are particularly important because forward-looking voluntary disclosures are a feared source of meritless suits. But the whole population of voluntary informative disclosures, if measured, seems likely to be far greater than the voluntary forward-looking disclosures that lead to meritless suits. Finally, there is the likely effect of increased informative disclosure on the frequency and outcome of meritless suits.

Fuller disclosure should lead to smaller claims because the stock market would have more realistic expectations of the company's prospects. The smaller the discrepancy between the valuation implicit in the market price and the valuation based on a company's true prospects, the smaller declines in share prices from disappointed expectations. Since damages are based on the extent of the decline, the smaller declines would lead to smaller damage claims.

Defendants should have better defenses. Assume, for example, richer disclosure of company risks. Defense attorneys could point to such disclosures to argue that the plaintiffs were adequately informed of the potential decline in share prices. This would increase the proportion of cases won by defendants and reduce the settlement amounts. The more important effect is the reduction in settlement amounts, because the cost of pursuing litigation leads to the settlement of most securities class actions.

There should be fewer suits as a consequence of the two conditions just cited. A higher proportion of the share-price declines would be too small to justify a suit. Better defenses from richer disclosure would warn class-action attorneys that they would have a more difficult time winning and would gain less in settlement. This also would be factored into class-action attorneys' decisions to bring suit.

Some believe that litigation costs increase with increased informative disclosure, and it is possible that they do. However, the analysis above indicates that considered in full context (that is, the full population of suits and the full population of disclosure events as well as the influence of informative disclosure on meritless suits), litigation costs do not increase with the extent of the disclosure. Rather, it appears from the analysis that increased informative disclosure reduces litigation costs on average. However, both points of view agree that with respect to disclosure of forward-looking information, the potential cost is high and regulatory and statutory relief is needed.

**Competitive Disadvantage**

Disclosure that would weaken a company's ability to generate future cash flows by aiding its competition is not in the interests of the company. However, looked at fully, the effect of disclosure on competitiveness is complicated and uneven, involving benefits as well as costs.

Some types of information that might create competitive disadvantage are:

- Information about technological and managerial innovation (for example, production processes, more effective quality-improvement techniques, marketing approaches).
- Strategies, plans, and tactics (for example, planned product development, new market targeting).
Four factors determine whether information in the categories above creates competitive disadvantage: the audience for the disclosure, the type of information, the level of detail, and the timing of the disclosure. Disclosure restricted to a capital supplier ordinarily would not create competitive disadvantage, whereas the same disclosure to the disclosing company's industry might. As for the type of information, routine operating data are less likely to cause competitive disadvantage than information on product development. However, the greater the level of detail about new product plans — for example, including all unique features and the reasons for their potential appeal — the greater the likelihood of competitive disadvantage. Similarly, the level of detail about segment disclosure determines whether it can cause competitive disadvantage.

The timing of a disclosure affects its potential for competitive disadvantage because at some age disclosure simply loses its capacity to create competitive disadvantage. Strategies become obvious from actions, and information about them then no longer can lead to competitive disadvantage. Products in development eventually come to market, and the closer to that eventuality the disclosure of product plans, the less time there is for a competitor to respond.

Even with awareness of the factors just cited, it is difficult to generalize or be certain about the effect of particular disclosures on competitiveness. For example, the potential competitor determining the investment hurdle to enter an industry might as likely be dissuaded by the disclosures as convinced to become a competitor.

There is also disclosure behavior that runs counter to the notion of competitive disadvantage. New products sometimes are announced early in order to convince competitors the market has been taken and to give the product a head start in name recognition. Announcements of new products and planned products are also a form of public relations, keeping a corporate name in the public mind associated with progress. Finally, product plans often are revealed to users in order to keep or win their support.

There is a vast difference between the purpose of disclosure to users, on the one hand, and competitors' purposes, on the other. The purpose of disclosure to users is to help them to estimate the amount, timing, and certainty of future cash flows from investing in the disclosing entity. Competitors are not trying to predict a company's future cash flows, and information solely of use in that endeavor is not of use in obtaining competitive advantage. Overlap between information designed to meet users' needs and information designed to further the purposes of a competitor is therefore coincidental.

Competitors have sources of competitor information other than public reporting to users. Any full dissection of the degree to which public disclosure affects competitive disadvantage would have to consider such sources.

Every company that could suffer competitive disadvantage from disclosure could gain competitive advantage from comparable disclosure by competitors. There cannot be competitive disadvantage for one company without one or more others gaining competitive advantage. Assuming it is required, competitors would have access to each other's disclosures. This suggests a net equality of competitive advantage and disadvantage for each company. However, individual circumstances undoubtedly would differ. A technological leader presumably would have more to lose in reciprocated technological disclosure than a technological laggard. And those subject to direct competition from foreign companies with lower levels of disclosure could suffer competitive disadvantage from disclosures used by those competitors without access to the reciprocal disclosure that could bring offsetting competitive advantage. Nevertheless, for any given company, competitive advantage from others' disclosures or the potential for such advantage must be counted along with whatever competitive disadvantage stems from that company's own disclosures.

This creates the concept of net competitive disadvantage from disclosure. It would vary from company to company and from time to time, could be positive or negative, and could therefore also be called net competitive advantage from disclosure.

**The Competitive Effects of Disclosure on the Economy**

To the degree that disclosure adds to competition among U.S. businesses, other things being equal, it serves
the public interest in greater economic efficiency and national competitiveness. The economic advantages of competition have been part of our national political ideology and law for generations (for example, the antitrust laws and the Federal Trade Commission's mandate to fight restraints on trade). Anticompetitive features in other societies are widely cited by economists to explain slow growth and difficulties in emerging from a recession.

However, the United States is not a land of unfettered competition. There are types of trade protection and subsidies that reduce the vigor of marketplace competition. In addition, there are specific devices to give monopoly advantages to companies and other economic agents. These are patents, copyrights, and trade secret law. The economic rationale for such devices is that a certain level of anticompetitive advantage is necessary to encourage innovation and risk taking. Discussions of competitive disadvantage from disclosure must consider that these devices protect competitive advantage that otherwise might be lost from disclosure, and the idea that enhanced competition from disclosure is a public benefit must be seen in light of the tempering effect of such devices on the level of competition.

International competition is an exception to the idea that enhanced competition from disclosure is a public benefit. Foreign companies selling to the U.S. market do not have in their Home countries the same disclosure requirements that U.S. companies have here. It is typically more costly for U.S. companies to prepare disclosure under the U.S. requirements, a competitive disadvantage. Another competitive disadvantage is that U.S. disclosures allow foreign competitors to know more about publicly traded U.S. companies than such companies know about competitors from abroad.

One mentioned remedy, assuming it were available, is the so-called level playing field, a U.S. level of disclosure identical to the levels in foreign competitors' home countries. However, equality of disclosure by itself is not a rational approach to public interest. It ignores the quality and sufficiency of disclosure. A playing field with no disclosure, foreign or domestic, is as level as any other, but not one that is publicly beneficial. An approach that totally ignores the objectives of effective capital allocation and the interests of users cannot be considered rational. The benefits of informative disclosure obviously weigh against leveling by reducing such disclosure. Moreover, the U.S. has long had a distinction between public company and private company disclosure requirements that is inconsistent with a purely level playing field on disclosure.

There is also the question of what is meant by a playing field. A disclosure system is only part of a capital-allocation system and cannot be understood out of that context. This point is made in the study on national competitiveness by Michael Porter of Harvard Business School for the Council on Competitiveness. Porter notes that German and Japanese enterprises have fewer external reporting requirements but have closer, long-term relationships with dominant owners, who are informed by other mechanisms. In this way Porter justifies recommending more and better disclosure in the U.S. to improve capital allocation in the interest of national competitiveness. For our purposes, the differences among national capital-allocation systems mean that comparisons based on disclosure alone must be considered incomplete.

Globally harmonized disclosure standards that adequately serve users' needs and meet cost-benefit tests would be consistent with the premises and recommendations of the Committee and end the problem of international differences in disclosure. But that is down the road. For the present, it is important to note that U.S. companies can raise capital abroad if they choose to or engage in private placements in the U.S. Their decisions to stay in the U.S. public market suggest its advantages outweigh its disadvantages. The advantages include low cost and liquidity that are partly attributable to disclosure.

The U.S. also has an interest in attracting overseas companies to its capital markets. However, the arguments that apply to the public interest in the disclosures of domestic issuers apply to foreign issuers. It is again in the public interest, for example, that the stock of U.S. capital be allocated effectively and for the markets to be liquid. The presumable attractions to foreign issuers are lower capital costs and increased liquidity, and fuller disclosure serves those interests.

**Bargaining Power**

Companies bargain with suppliers and with customers, and informative disclosure could give those parties an advantage in negotiations. In such cases, the advantage would be a cost for the disclosing entity. However, the cost would be offset whenever informative disclosure was presented by both parties, each in that case receiving an advantage and a disadvantage.
Company Behavior

Companies sometimes alter their behavior in response to disclosure requirements or the information that is disclosed, and the behavior can lead to costs or benefits.

However, it is very difficult to predict the results of disclosure on company behavior. The imminent adoption of the FASB’s pronouncement on contingencies in 1975 led to predictions that corporate risk and insurance management would be changed with adverse consequences. In a study performed after the Statement was issued, however, Robert C. Goshay found there were no impressive differences between the risk-management decisions of the companies he studied and those of a control group. A similar story occurred with FASB’s controversial first statement on foreign currency translation in 1975. A post-issuance study three years later found no overall detriment to companies or society and some benefits (for example, companies became more aware of exchange risk and more sophisticated in evaluating the cost of foreign currency transactions).

There seems no basis for concluding that the extent of the disclosure results either in net damage from company behavior or net benefits. Each case is unique. However, if new disclosure is truly informative and previously underappreciated by management, as was the case with the costs of postretirement medical benefits, there is likely to be a net economic benefit.

Public and Private Companies

Although most of the examples given above cite public company disclosure situations, the benefits and costs of informative disclosure applicable to public companies also apply to private companies. The difference is one of degree rather than kind. For example, competitive disadvantage and litigation risk are limited by the narrower distribution of disclosure, but both are applicable. Private companies are sometimes concerned about whether a supplier that receives disclosure reveals such information to the disclosing company’s competitor that is also the supplier’s customer. The costs of developing disclosure are typically lower absolutely for private than for large public companies, but they can be more important relatively. Informative disclosure by private companies contributes to the social benefits of improved capital allocation and lower cost of capital.

The main benefits and costs of informative disclosure discussed above are summarized in exhibit 1.

<table>
<thead>
<tr>
<th>Exhibit 1</th>
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<tbody>
<tr>
<td>MAIN BENEFITS AND COSTS OF INFORMATIVE DISCLOSURE</td>
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<tr>
<td>(To Be Understood as Described in the Text)</td>
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</table>

**Benefits**

- The economy benefits from
  - more effective allocation of capital.
  - the investment effect of a lower cost of capital.
  - more liquid capital markets.
  - enhanced efficiency from competition.
- Entities (and their owners) benefit from
  - a lower average cost of capital.
  - access to more liquid markets.
  - reduced likelihood that they will misallocate their capital (as users of other companies’ financial statements).
  - avoided litigation alleging inadequate informative disclosure.
  - bargaining advantage from customers’ and suppliers’ informative disclosure.
  - instances where new disclosure is truly informative and previously underappreciated by enterprise management.
Society benefits from the consumer protection provided by informative disclosure.

Costs

- Owners bear the cost of developing and presenting disclosure.
- Entities (and their owners) bear the costs of
  - competitive disadvantage from their own informative disclosure.
  - bargaining disadvantage from their own disclosure to suppliers and customers.
  - litigation from meritless suits attributable to informative disclosure.
- The economy bears the costs of
  - the drag on growth from meritless suits attributable to informative disclosure.
  - competitive disadvantage from lower disclosure requirements in foreign competitors’ Home countries.
  - developing, presenting, understanding, and analyzing informative disclosure.

Applying the Committee's Approach

The three steps in the Committee’s approach, as already noted, were identifying the benefits and costs of decision-useful information, identifying types of information that could provide significant benefits, and developing cost-limiting criteria to identify recommendations that could impose potentially significant costs. These steps were not taken in sequence, but each represents a set of actions taken by the Committee.

The Committee developed its potential recommendations based on their potential benefits, identifying decision-useful information from its study of users, as described in chapter 3. The Committee's benefit estimates relied more on users' needs data than on any other source. This was supplemented by the study of the generic benefits of disclosure.

The Committee's consideration of costs was at first based on members' experience with financial reporting and later supplemented by the study of generic costs. However, once recommendations were developed, they were tested for cost-effectiveness through consultation with preparers of financial reports, who provided useful information on potential costs as well as other substantive commentary. The primary source for information on the problems that tentative recommendations might pose for private companies was accountants serving private companies, including the AICPA Private Companies Practice Section's Technical Issues Committee, a group responsible for being aware of the reporting interests of private companies.

These processes yielded the following criteria on benefits and costs of candidate disclosures:

- Is the information about the company? This is both a benefit and a cost criterion. Users of business reports need company-specific data, and it is typically more costly to obtain and present information about matters external to the company.
- Is the company the best source for the information? This is primarily a cost criterion and is related to the prior one. It could be inefficient for a company to obtain or develop data that other, more expert parties could develop and present or do develop and present — for example, about matters external to the company. The criterion is a benefit criterion when seen from the perspective of the user because it is in the user's interest to use information from the best source.
- Is the information significantly helpful in valuing the company or assessing its credit risk?
This is primarily a benefit criterion. However, by eliminating the non-germane from the user's analysis, it also has a cost-limiting function.

- Are the litigation costs of providing the information potentially significant?
- Are the competitive costs of providing the information potentially significant?
- Are the costs of preparing, auditing, and disseminating the information potentially significant?

The flowchart in exhibit 2 both illustrates those criteria and gives examples of information excluded from the Committee's recommendations as a result of applying those criteria.

In applying its cost-benefit criteria, the Committee was aware that there is a distinction between its recommendations and draft standards. Recommendations might or might not lead to draft standards. Moreover, since recommendations are far more general than standards, a variety of standard-setting outcomes could result from the translation of recommendations into standards, with commensurately different costs and benefits. It therefore would be impossible as well as inappropriate to treat the recommendations as draft standards. The question for the Committee was, and could only be, whether its recommendations are sufficiently cost-beneficial to merit consideration by standard setters, not whether its recommendations are sufficiently cost-beneficial to be implemented.
Conclusion

The Committee's approach to benefits and costs was conservative. First, it was based on the research evidence already described. Second, the evidence showed that there are many benefits to informative disclosure, some traditionally underappreciated, and that users have unmet information needs. Third, the approach was stringent despite the fact that any proposed standards that emerge from the Committee's recommendations will be subjected to cost-benefit analysis by the standard setters. Fourth, and most important, its cost-limiting criteria address directly every one of the three major costs that a disclosing company could face — preparation and dissemination, competition, and litigation. (The Committee's criteria to limit costs are discussed in chapter 5.) Moreover, the cost-limiting criteria on competition and on litigation are arguably in tension with the findings from the analysis of generic benefits and costs.

The findings on competition showed there are potential benefits to be had. Companies that suffer competitive disadvantage from disclosure could benefit from reciprocated disclosure by their competitors, and enhanced competition provides some benefits to the economy. However, the Committee decided that the risk of competitive disadvantage to the disclosing company should take priority.

The findings on litigation showed that informative disclosure could be beneficial in defending and avoiding litigation. In this instance, the Committee decided that the risk of litigation from forward-looking information should not be ignored.

The approach is conservative, finally, when one considers likely changes in benefits and costs in the future. The Committee attempted to estimate coming changes in the generic benefits and costs it identified, even though the exercise obviously involves additional uncertainties. One finding stood out — the influence of information technology on the costs of preparing, disseminating, acquiring, and interpreting informative disclosure. Even if one postulates increasing disclosure, there would still be a cost-of-preparation decline in the long term. This is quite different from the assumption in the criterion above that puts a high priority on avoiding excessive costs from preparing and disseminating disclosure. Put another way, the effect of progress in information technology would increase the optimal disclosure level for companies — that is, the level at which they incur minimal net costs (receive maximum net benefits) from disclosure.

Of course, we cannot know with any certainty what the optimal disclosure level is today for individual companies, for all companies as a group, or for society as a whole. Some companies through voluntary disclosure may have achieved their optimal level, benefiting fully in their cost of capital. But there are no quantitative measures of how today's levels of disclosure stand with respect to optimal levels. Standard setters must make such estimates as best they can, guided by prudence, what evidence of benefits and costs can be obtained (such as data on investors’ needs), awareness of the types and interrelationships of benefits and costs, and their understanding of the trade-offs that best serve the public interest.
Chapter 5 — Improving the Types of Information in Business Reporting

Based on the information needs of users and the costs and benefits of suggested improvements, the Committee recommends changes in four areas: improving the types of information in business reporting, improving financial statements, improving auditors’ involvement with business reporting, and facilitating change. This chapter addresses the Committee's recommendations in the first area.

Business reporting cannot and should not meet all users' needs for information. It would be too costly to do so and, as discussed in chapter 3, users want information from multiple sources. However, business reporting should include all information that meets the broad range of users' needs for information but be restricted by two conditions: (1):NSP:the information should be within management's expertise (that is, management should be the best source for the information) and (2):NSP:the information should be provided at acceptable cost.

Within those constraints, however, it is important that the information provided by business reporting be as complete as possible — it must address the broad range of users' needs for information. Because of dramatic changes in the environment affecting business, users may require new types of information. At the same time, companies may develop, for management purposes, new types of information that users would find useful, and some information traditionally provided no longer may be necessary. Because of those changes, standard setters and regulators constantly must update their understanding of users' needs for information and the information management has available for internal purposes that could assist users to ensure that business reporting is as complete as possible considering the costs of providing the information.

This chapter discusses the Committee's recommendation to develop a comprehensive model of business reporting and describes the model developed by the Committee. It also discusses the Committee's recommendation for further study of benefits and costs to improve decisions about the types of information that business reporting should provide.

A Comprehensive Model of Business Reporting

Recommendation 1

Standard setters should develop a comprehensive model of business reporting indicating the types and timing of information that users need to value and assess the risk of their investments.

In business reporting, standard setters have recognized the usefulness of models or frameworks. For example, the FASB has developed its conceptual framework, which sets forth the fundamentals on which financial accounting and reporting standards should be based, including the nature of information that should be included in financial statements. Other standard setters also have established frameworks for financial statements that guide the direction of future standards.

Unfortunately, existing reporting models focus narrowly on financial statements rather than on the broad range of users' information needs. Users would benefit from business reporting based on a comprehensive model that prescribes all the types and timing of information that could be made available to them. Such a comprehensive model also would help standard setters and regulators provide guidance on the information content within business reporting. A comprehensive model would:

- Focus reporting on users' needs for information.
- Broaden the focus from financial statements to the wider array of information necessary to meet users' needs for information.
- Identify high-priority projects for standard-setting agendas. Business reporting is falling short of providing all of the useful information it should provide to meet users' needs for information. The comprehensive model would identify the gaps, indicating high-priority projects.
- Provide a platform for considering cost-benefit issues.
- Provide a framework for setting specific standards in a manner that is directionally consistent and integrated with other standards and users' needs for information.
• Streamline reporting by purging redundancies in disclosure and identifying unnecessary disclosure requirements.
• Organize reporting in a manner that enables users to retrieve information easily.
• Provide a vehicle for experimentation, thereby field testing concepts in advance of formal standard setting.
• Provide users and companies with a menu of reporting elements (types of information) that would facilitate their agreement about the types of information to be provided to users in particular circumstances.

The comprehensive model should be based on general concepts that guide reporting under the model. The Committee recommends the following concepts that it learned from its study of users’ needs:

• Report separately on each segment of a company’s business having diverse opportunities and risks.
• Explain the nature of a company’s businesses, including the linkage between events and activities and the financial impact on a company of those events and activities.
• Provide a forward-looking perspective.
• Provide management’s perspective.
• Indicate the relative reliability of information in business reporting.
• Focus on measurement to help users understand a company’s performance relative to that of competitors and other companies.
• Promptly communicate important changes affecting a company.
• Allow for flexible reporting.
• Communicate effectively and efficiently.
• Consider the costs and benefits of business reporting.

The first seven concepts are based on concepts of users’ needs for information discussed in chapter 3. The remaining three, which also are consistent with users’ needs for information, are discussed in the following section.

**The Committee's Comprehensive Model of Business Reporting**

To assess the feasibility of its ideas, the Committee designed and illustrated a comprehensive model based on the above concepts, its understanding of users’ needs for information, and information about costs of reporting. Much of the information in the model would replace, not be in addition to, information currently contained in filings by U.S. public companies with the SEC.

In addition to the discussion of the Committee’s business reporting model in this chapter, the details of the model, listing specific types of information within broad categories of information, are outlined in appendix II and the model is illustrated, using a fictitious company, FauxCom, in appendix III.

**Overview and How the Model Meets Users' Needs for Information**

The model divides reporting into elements (general types of information) that address the broad range of users’ needs for information. As financial statements provide a useful structure for financial information, so would the elements of the model provide a useful structure in the broader arena of business reporting.

The model includes ten elements within five broad categories of information that are designed to fit the decision processes of most users and are consistent with the types of information the Committee's study indicated users find useful (see exhibit 1, p. 52). Nine of those elements result directly from the Committee’s study of the types of information that users find useful, as discussed in chapter 3. The tenth — the comparison of actual business performance to previously disclosed opportunities, risks, and management's plans — was added by the Committee to improve the reliability and credibility of information and to help users assess the relative reliability of information.
THE TEN ELEMENTS OF THE COMMITTEE’S MODEL OF BUSINESS REPORTING

Financial and non-financial data

- Financial statements and related disclosures
- High-level operating data and performance measurements that management uses to manage the business

Management’s analysis of the financial and non-financial data

- Reasons for changes in the financial, operating, and performance-related data and the identity and past effect of key trends

Forward-looking information

- Opportunities and risks, including those resulting from key trends
- Management’s plans, including critical success factors
- Comparison of actual business performance to previously disclosed opportunities, risks, and management’s plans

Information about management and shareholders

- Directors, management, compensation, major shareholders, and transactions and relationships among related parties

Background about the company

- Broad objectives and strategies
- Scope and description of business and properties
- Impact of industry structure on the company

The model is consistent with the ten concepts of users' needs for information listed above. Chapter 3 discusses how the types of information in the model meet the first seven of those concepts. The remaining three concepts and how the model meets those concepts are discussed below.

*Allow for Flexible Reporting*

As discussed in chapter 3, users have different needs for information depending on the circumstances. For example, a short-term trade creditor may need far less information than a long-term equity investor. Further, the costs of reporting information also differ depending on the circumstances. Because needs for information and costs of reporting differ, not all companies should report all types of information with the same frequency and in the same time frame. Identical reporting by all companies would result in excessive costs and, in many cases, provide more information than is needed. Rather, the types and timing of information in business reporting should be customized to meet users' needs and cost constraints in the particular circumstances.
The elements of the model provide a menu of choices that allows flexible reporting. More specifically, companies and users should negotiate and agree on several aspects of reporting:

- **Type of information.** Business reporting should include at least the financial statement element and such other elements of the model as users and companies agree should be provided in the particular circumstances. The financial statement element always should be part of business reporting, because users need financial statements in nearly all cases when they need business reporting. Further, users have no way to obtain financial statements other than through business reporting.
- **Frequency of reporting.** Companies and users should agree on the frequency that users receive updated reporting (monthly, quarterly, annually).
- **Time frame of reporting.** Companies and users should agree on the number of historical periods on which a company reports information.
- **Timeliness of reporting.** Companies and users should agree about the delay between the close of a reporting period and the time information about that period is reported to users.
- **The extent and nature of auditor association.** Companies and users should agree on the elements of information on which auditors should report, if any, and the nature of the auditors' association with the information in those elements (audit, review, or other). Auditor association is discussed in chapter 7.

As a practical matter, reporting flexibility based on negotiation mostly would be applicable to private companies and the users of their business reporting. Private companies generally deal with a limited number of users. Further, private companies and users already negotiate over the content, frequency, time frame, timeliness, and extent and nature of auditor association of business reporting. The Committee believes the flexible reporting feature of the model is a logical extension of a process of negotiation that already works well in practice. It helps ensure that only information truly needed and that can be provided at acceptable cost is included in business reporting.

The model assists the parties to the negotiation process with a menu of mutually understood elements of information from which to choose in defining the features of business reporting that are best in the particular circumstances. It is likely that standardized subsets of the menu of elements would emerge as particularly useful for lenders to privately held companies. Those standardized subsets would reflect, among other things, the nature, duration, and risk of the lending.

Users of public company business reports differ from users of private company reports in three respects. First, the users of a public company's reports are usually numerous and diverse, and they frequently change. Thus, few have sufficient bargaining power or resources to negotiate with specific companies over the content of business reporting. Second, relatively few users of public company reports have ready access to management or are willing to devote the resources to contact management. Thus, they must rely to a greater degree on business reporting for company-specific information. Finally, users of public company reports often are subject to insider-trading restrictions, which restricts them to a company's publicly available information.

As a result of those differences, business reporting by public companies must meet a broad range of users' needs for company-specific information. Further, the content and timing of reporting by public companies must be determined differently from the decentralized negotiation with users that works for private companies. For public companies, regulators, such as the SEC, historically have represented users' interests. Since business reporting by public companies must meet a broad range of users' needs, regulators may choose to receive from public companies most, if not all, of the model's elements. Thus, the Committee considered practical constraints, as discussed below, to reduce the costs of reporting under the model.

**Communicate Effectively and Efficiently**

Information should be communicated to users in an organized fashion that allows users to locate different types of information quickly. Information also should be provided in an integrated manner that eliminates redundancy, streamlines reporting, and provides only the information that users need. The information should be supplemented with charts and graphs to improve management's presentation and users' comprehension of the information. The information should be provided in either printed or electronic form, depending on which is more useful for users and after considering the costs involved. The model tries to improve the effectiveness and efficiency of communication in those ways.
Consider the Costs and Benefits of Business Reporting

Standard setters and regulators should continue to be sensitive to the costs of business reporting and search for ways to limit costs while still providing more useful information.

As discussed in chapter 4, weighing the costs and benefits of possible improvements to business reporting is difficult and complex. It is impossible to measure many of the costs and benefits of improved disclosure, such as the cost of disclosing competitively harmful information or the benefits to the economy of another piece of useful information. In addition, the costs and benefits affect people and groups in different degrees.

While difficult, cost and benefit decisions must be made. On the one hand, business reporting must be enhanced to maintain its relevance, while on the other hand, undisciplined expansion of mandated reporting could result in large and needless costs. Faced with this dichotomy, the Committee adopted a cautious and practical approach, proposing ideas supported by users that would result in truly useful information while recommending constraints on disclosure when costs could be significant. Thus, the model includes constraints to limit the costs of reporting, which are discussed below.

Reliability and Credibility

Improving the reliability and credibility of business reporting is a goal of the Committee's work. The Committee's recommendations in areas of improving the reporting model, auditor association, and facilitating change in business reporting each play a role in meeting that goal. The model would improve the reliability and credibility of business reporting by including elements that help ensure balanced, neutral reporting. The elements include (1) the reporting of risks as well as opportunities, (2) the focus on measurements in addition to qualitative discussion, (3) the comparison of actual business performance with previously disclosed forward-looking information, and (4) reporting about the uncertainty of reported measurements.

Practical Constraints of the Model

The Committee developed its model of business reporting subject to six constraints to reduce costs in areas where the costs of reporting under the model could be significant. Financial executives are very concerned about the costs to their companies of reporting under the Committee's comprehensive model. As discussed in chapter 4, those costs fall into three categories: the cost of developing and presenting information, the litigation risk attributable to disclosure, and the competitive disadvantage from additional disclosure. The Committee believes the practical constraints discussed below significantly reduce costs in each of those areas.

1. Business reporting should exclude information outside of management's expertise or for which management is not the best source. That is, business reporting should include only company-specific information that is within management's expertise to provide.

As discussed in chapter 3, users need a wide range of information, some of which is company specific and some of which is not. Examples of company-specific information are listed in the elements of the Committee's model. Other types of information include, for example, information about the general economy (past and expected interest rates, inflation, and growth), information about industry structure and conditions, and information about a company's competitors.

Business reporting should be restricted to company-specific information for two reasons. First, imposing a duty on management to report on the economy, a company's industry, competitors, and other non-company-specific information would impose serious costs to accumulate and report a boundless amount of information and possibly expose the company to high risks of litigation.

Second, most non-company-specific information is outside of management's expertise. Many managements have opinions about the future direction of the economy and probably strong views about the company's industry and competitors. However, users often have other sources that are as good as or better than management for information in those categories. For example, users have a wide variety of sources to form opinions about the general economy. They can refer to trade publications, government statistics, and analysts for information about an industry. Much of the information can be obtained at low cost.
In contrast, for company-specific information, management usually is the best source, and users have few alternatives to management for the information. Thus, with a few exceptions, business reporting should provide the company-specific information that users need. Those exceptions relate to company-specific information for which there is a better, lower cost source than management. Examples may include stock price and volume statistics for public companies (the stock exchange or market maker may be the best source), the company’s reputation with competitors and customers (competitors and customers would be the best sources), and market share data (government publications or industry trade associations may be the best sources).

2. Management should not be required to report information that would harm a company’s competitive position significantly.

Disclosing competitively sensitive information is a major concern for companies; for many, it is the single largest concern about the Committee’s recommendations. Companies are concerned that competitors would gain new insight from business reporting under the Committee’s model and use that insight to a company’s competitive disadvantage. To a lesser extent, companies are concerned that suppliers and customers also would gain new insights from improved reporting, thereby enhancing their relative bargaining position in price negotiations.

Disclosure of certain information can harm a company’s competitive position significantly. For example, disclosing a company’s estimate of the ultimate settlement amount related to litigation may harm its position in negotiating a settlement with the other party. As another example, disclosure of a company’s plans to market a new type of product and the reasons why management believes the product will be successful may alert competitors prematurely and cause them to accelerate their own development plans.

Companies should not be required to disclose information that would harm their competitive positions significantly. It is not in the interests of existing investors or creditors to require disclosures that would undermine the value of their investments or increase the credit risk of their loans. Further, disclosures that significantly undermine competitive position reduce the incentives of companies to seek competitive advantage — a critical feature of a free market system. Such disclosures also would undermine national competitiveness if, for example, U.S. companies were required to disclose competitively sensitive information that competitors in other countries need not disclose.

Deciding which disclosures would harm competitive position requires judgment. What is not harmful for one company may be harmful for another. Or what is harmful at one point in time may not be harmful if disclosed later. It is not possible to specify that disclosure of certain types of information is always harmful — the issue depends on the particular facts and circumstances. Thus, it is necessary to provide management, which is closest to the business, with the latitude to decide which specific disclosures would be significantly harmful and which would not.

Four factors mitigate the competitive costs of reporting under the model. First, competitors already know a lot of information about a company from the company’s former employees, mutual suppliers and customers, market research, and the marketplace itself. The competitive cost of disclosing information depends on the incremental insight that information brings to competitors relative to the competitors’ other sources of intelligence. Second, competitive costs are mitigated by the broad nature of information suggested under the model. Reporting under the model is generally at the business segment level, which is potentially useful to competitors but perhaps not as useful as lower level information, which is closer to where day-to-day competition is conducted. Third, every type of information suggested in the model already is reported voluntarily by at least some companies, suggesting that it is practical to disclose the information. Fourth, the insight competitors gain through access to a company’s segment information is at least partially offset by the insight that a company gains through access to its competitors’ disclosures. However, this last point is not valid in situations where competitors are not subject to the same reporting standards.

The constraint limiting disclosure of competitively sensitive information should not be used as an excuse to avoid making meaningful disclosure. It can be argued that nearly all disclosure could provide insight to competitors. The test is whether a disclosure would harm competitive position significantly, not whether disclosure could provide some insight. The linkage between the disclosure and harm should be clear and direct, such as with the examples on litigation and product development.

The Committee expects that the vast majority of information specified in its model can be provided in a form
that is significantly helpful to users while not harming competitive position significantly. Even information that would harm competitive position often can be repackaged in a form that is not harmful while still being helpful to users. For example, companies can discuss issues at a higher level than the level that would provide competitors with harmful information. Using the lawsuit example discussed earlier, a company could disclose information about a group of lawsuits rather than a particular lawsuit, describing the nature of the claims, the amount of the accrual for the group of claims, and information about the measurement precision for the claims as a group, such as the range of possible loss. As another example, companies could delay the disclosure of information until disclosure is no longer harmful. In the new product example discussed earlier, a company could disclose the new product and its features concurrent with the product's release in the marketplace. Before that point, a company could disclose information about its product-development function — such as its historical ability to be first to market with innovative and successful products, and the trend in the company's product-development lead time.

3. **Management should not be required to provide forecasted financial statements.** Rather, management should provide information that helps users forecast for themselves a company's financial future, such as the information specified in the Committee's model.

The approaches used by many users to value companies or assess credit risk require forecasted financial data. Usually, that forecasted data is the result of considerable effort by the forecaster after analyzing the types of information listed in the Committee's model. Despite the relevance of forecasted financial data, users generally do not need forecasted financial statements for the reasons discussed in chapter 3. Further, it is unreasonable to require forecasted financial statements in an environment where there is a high risk of subsequent unwarranted litigation, claiming, with the benefit of hindsight, that the statements failed to predict the future accurately.

4. **Other than for financial statements, management need only report the information it knows.** That is, management should be under no obligation to gather information it does not have, or need, to manage the business.

Reporting only the information that management knows is consistent with the objective of providing management's perspective on the business. It allows users to understand the measurements that management is emphasizing, which, in turn, helps users predict where and how management will lead a company. It also reduces the cost of reporting under the model. Requiring management to search for information it does not have in the broad areas of users' needs for information would be costly, would divert management's attention away from running the business, and would create an unrealistic expectation that management could not meet.

An exception to the rule that management report only what it knows is appropriate for financial statements, which consist of tightly interwoven information. With financial statements, failing to obtain one kind of information usually affects other information as well. For example, failing to recognize a liability affects the particular class of liabilities, total liabilities, the ratio of liabilities to equity, measures of income, and others. Further, if financial statements were based only on available information, they would be less comparable among companies. Also, for many years, companies have been required to prepare financial statements according to well-defined standards, even if doing so requires them to obtain information they do not have. Users support that practice, and the Committee sees insufficient reason to change it.

In concept, the non-financial data included in the model, such as operating data and performance measurements, also should be prepared according to standards to enhance the comparability of the information. However, there currently is insufficient agreement about the types of those measures and how they should be computed to permit development of generally acceptable standards. Limiting disclosure of non-financial data to what is available is a practical way to begin the process of reporting that information.

5. **Certain elements of business reporting should be presented only if users and management agree they should be reported — a concept of flexible reporting.**

The model's flexible reporting concept is effective in reducing the costs of reporting under the model. It does so by decentralizing decisions about the content and timing of business reporting to a company and the users of its business reporting. They are in the best position to assess the costs and benefits of reporting in the particular circumstances.
6. **Companies should not have to expand reporting of forward-looking information until there are more effective deterrents to unwarranted litigation that discourages companies from doing so.**

The cost of disclosing forward-looking information, as defined in the Committee's model, is unacceptably high because of the high risk of unwarranted litigation in the current legal environment. Forward-looking information that, with the benefit of hindsight, failed to predict the future accurately is already an easy target for unwarranted lawsuits filed routinely against companies whose stock prices have fallen. Increasing the focus on forward-looking information, as suggested in the model, would increase unwarranted litigation and the resulting costs of defending and settling the suits. Changes that discourage unwarranted litigation are urgently needed before there can be any meaningful improvement in the forward-looking information companies provide.

Forward-looking information would help users for the reasons discussed in chapter 3. Thus, the Committee outlined in the model the nature of that information in the hope that lawmakers and regulators adopt ways of discouraging unwarranted litigation, thereby permitting cost-effective disclosure of forward-looking information. Certainly, the right to sue for recovery for legitimate claims must be preserved, but the current system is out of balance and is undermining business reporting by depriving users of useful information. The impact of unwarranted litigation on business reporting is discussed in chapter 8.

**Differences Between the Comprehensive Model and Business Reporting by U.S. Public Companies**

The Committee's comprehensive model differs from current reporting by U.S. public companies to the SEC in six areas: (1) business segment perspective, (2) financial statements, (3) high-level operating data and performance measurements, (4) management's analysis, (5) forward-looking information, and (6) background information. Differences in each of those areas are discussed below.

**Business Segment Perspective**

Reporting information about business segments is a key feature of the model and applies to most of the model's elements. As discussed in chapter 3, for users analyzing a company involved in diverse businesses, information about each business segment often is as important as information about the company as a whole. For many users, the business segment is the unit of analysis. Thus, companies should report information about their business segments in addition to information about the company as a whole.

At a minimum, multisegment companies should report business segments on an industry basis, for the reasons discussed in chapter 3. Companies also should report segment information on a geographic basis if that information is useful to users in understanding opportunities and risks that a segment faces. In general, multisegment companies would report on more industry segments under the model than they report on in current practice. Determining which industry and geographic segments, if any, on which to report is discussed in chapter 6.

For a company with more than one industry segment, most types of information specified by the model will apply to the industry segment level. The goal of the segment breakdown of information is to permit the user, to the extent practicable, to analyze how the different opportunities and risks of business segments are being managed by the company.

The FauxCom example in appendix III illustrates the model's concept of segment reporting. FauxCom consists of two industry segments: the PC Segment and the Integration Segment. In that illustration, most of the types of information in the model are provided for each of the two segments, as shown in exhibit 2. The only information not provided at the segment level is information about management and shareholders, which applies to the company as a whole.
### SEGMENT PERSPECTIVE IN FauxCom ILLUSTRATION

<table>
<thead>
<tr>
<th>The Ten Elements of the Committee's Model of Business Reporting</th>
<th>Perspective</th>
<th>Segment</th>
<th>Company</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Financial and non-financial data</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Financial statements and related disclosures</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>• High-level operating data and performance measurements that management uses to manage the business</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Management’s analysis of the financial and non-financial data</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Reasons for changes in the financial, operating, and performance-related data and the identity and past effect of key trends</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td><strong>Forward-looking information</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Opportunities and risks, including those resulting from key trends</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>• Management’s plans, including critical success factors</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Comparison of actual business performance to previously disclosed opportunities, risks, and management’s plans</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Information about management and shareholders</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Directors, management, compensation, major shareholders, and transactions and relationships among related parties</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Background about the company</strong></td>
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</tbody>
</table>
The Committee's model focuses more on reporting at the segment level than does reporting in current practice. For example, private companies are exempt from disclosing segment data in financial statements. Public companies must report at the segment level in financial statements and in the description of the business and properties section of form 10-K. However, in MD&A, discussing operations at the segment level is up to management's judgment, and many companies do not clearly segregate their discussions on a segment basis.

Financial Statements

The Committee's study of users' needs confirmed the importance of financial statements and related disclosures. There is little evidence that users are abandoning their analyses of financial statements because they believe the information is becoming irrelevant. No user suggested that financial statements should be scrapped and replaced with a fundamentally different means of organizing financial information. Thus, the model generally retains the form and content of today's financial statements and related disclosures.

Despite the general vote of confidence about financial statements, however, users were strongly critical about certain aspects of financial reporting, and they offered or supported many substantive ideas for its improvement.

The Committee developed recommendations to improve financial statements and related disclosures based on both user criticism of financial statements in current practice and the Committee's understanding of users' needs for information and ideas to better align business reporting with those needs. Those recommendations are discussed in chapter 6 and are reflected in the model in appendix II.

High-Level Operating Data and Performance Measurements

The Committee's model includes high-level operating data and performance measurements that management uses to manage the business. With certain exceptions, U.S. public companies currently are not required to report that type of information, although many voluntarily provide substantial information of this type.

As discussed in chapter 3, high-level operating data would help users understand the business, and in particular, the linkage between events and activities and the financial effects on a company of those events and activities.

Performance measurements also would be useful. There is nothing new about corporate executives' use of performance measurements to manage their businesses. Manufacturing companies, for example, have been using the reject rate on goods produced and sales order backlog for many years. Performance measurements sometimes are published. For example, the findings of J.D. Power & Associates, a consulting group that conducts auto industry surveys of vehicle quality and customer satisfaction, are cited, as are Neilson ratings for the broadcast industry. Comparisons of patents obtained per year sometimes are published to demonstrate
technological leadership. Companies may advertise their performance through non-financial measures to create competitive advantage (for example, airline on-time data), suggesting a link between the measure and potential revenue.

Increased competition and rapid advances in technology are driving dramatic changes. In response to changes in their businesses, companies also are changing their information systems and the types of information they use to manage their businesses. A host of new types of performance measures have become more widely used by management, some in connection with the movement to total quality management (TQM), which emphasizes the benefits of measuring the performance of key processes and the primacy of customer satisfaction. Benchmarking is both a feature of TQM and a management tool in its own right. Performance measurement has taken on a role in today's managerial practices far greater than before, and it is growing.

Major initiatives around the world are considering what additional performance measures are needed. For example, the Financial Executives Research Foundation is considering the use of performance measures in its project on Economic Reality in Financial Reporting. The Conference Board has announced an international study evaluating non-traditional measures of corporate performance. A new body based in London, the Performance Measurement Foundation, was set up in 1992 to extend the scope of performance measurement beyond the conventional focus on internal, historical, financial, numeric, and short-term information. In addition, many private entities, including accounting firms, are helping companies rethink performance measurement.

Can effective business reporting exclude new performance measures on which management is focusing to manage the business? Managerial use of non-financial measures in running a business suggests users would benefit from access to the measures. Users share with management a vital interest in a company's future cash flows and earning capacity. Further, the Committee's study indicates users believe they would benefit from greater access to the high-level performance measures management is using to manage the business. The Committee believes that disclosure of performance measures would:

- **Provide leading indicators about a company's future.** Because of changes in the business environment and within companies, predicting a company's financial future is not merely an extrapolation of trends in a company's financial past. And because those changes are accelerating, the financial past may be an ever-weaker indicator of a company's financial future. Users are forever searching for better leading indicators of performance — indicators about existing conditions that provide insight into a company's future performance. Since future performance is often a function of how well a company performs key activities, performance measurements are often superior leading indicators of a company's performance.

- **Provide insight into the nature of a company's business.** Operating statistics often describe a company's activities in more tangible and understandable terms than do financial measures.

- **Provide perspective on sources of future cash flows unrecognized by the accounting model.** For example, information on average hours of training or employee satisfaction could help users assess a company's human resource position. Measures on customer retention may help a user understand the effectiveness of a customer base.

- **Provide insight into management's focus.** Disclosing the data that senior management uses to manage the business provides users with insight into management's focus and the direction management intends to take a company.

- **Provide users with a longer term focus about the activities that build shareholder value and protect creditors.**

High-level operating data and performance measures will vary by industry and by company. Management should identify measures it believes are significant and meaningful to its businesses and that are leading indicators of a company's future. Management need not report operating data or performance measures it does not already have or need to manage the business.

Operating data and performance measurements should be presented for the same periods as the financial statements. Companies should consider disclosing operating data and performance measurements in the categories listed in exhibit 3 (p. 62).
<table>
<thead>
<tr>
<th>Category</th>
<th>Examples Used in FauxCom Illustration</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Statistics related to activities that produce revenues, market</td>
<td>• Number of design and installation contracts in Integration Segment</td>
</tr>
<tr>
<td>acceptance, and quality, such as units and prices of product or</td>
<td>• Percentage of contracts awarded to number of proposals</td>
</tr>
<tr>
<td>services sold, growth or shrinkage in market share, measures about</td>
<td>• Percentage of contracts renewed</td>
</tr>
<tr>
<td>customer satisfaction, percentage of defects or rejections, and backlog</td>
<td>• Market share in PC Segment</td>
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<tr>
<td>2. Statistics related to activities that result in costs, such as the</td>
<td>• Average number of employees in each segment by function</td>
</tr>
<tr>
<td>number of employees and average compensation per employee and the</td>
<td>• Average consumption per employee</td>
</tr>
<tr>
<td>volume and prices of materials consumed</td>
<td>• Value of purchased components and materials as a percentage of cost of sales</td>
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<tr>
<td>3. Statistics related to productivity, such as the ratio of outputs in</td>
<td>• Number of PCs produced per employee</td>
</tr>
<tr>
<td>inputs</td>
<td>• Gross margin per employee in Integration Segment</td>
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<td></td>
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<tr>
<td>4. Statistics related to time required to perform key activities, such</td>
<td>• Product-development lead time in PC Segment</td>
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<tr>
<td>as developing new products or services</td>
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<tr>
<td>5. Statistics related to the amount and quality of key resources,</td>
<td>• Employee turnover in Integration Segment</td>
</tr>
<tr>
<td>including human resources, such as the average age of key assets or the</td>
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<td>quantity of proven reserves of natural resources</td>
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<tr>
<td>6. Measures related to innovation, such as the percentage of units</td>
<td>• Expected growth in new consulting services contracts in Integration Segment</td>
</tr>
<tr>
<td>produced in the current year that were designed in the last three</td>
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<tr>
<td>years or the number of suggestions to improve business processes</td>
<td></td>
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<tr>
<td>received from employees in the last year</td>
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</tbody>
</table>
7. Measures of employee involvement and fulfillment, such as employment satisfaction and the rate of change in that measure

- Employee turnover in Integration Segment

8. Measures of strength in vendor relationships, such as vendor satisfaction

- None used to manage the business

Management's Analysis

Both the Committee's model and current practice by public companies include management's analysis. However, the notion of management's analysis in the model differs in important respects from management's analysis in current practice. The Committee has rethought the concept and role of management's analysis within its notion of a comprehensive model of business reporting. It also has tried to respond to users' concerns about current practice, as listed in chapter 3. The following summarizes the major differences between the Committee's concept of management's analysis and current practice:

- The model suggests that companies disclose key operating data and non-financial performance measures that management uses to manage the business. Management's analysis should address trends and changes in those data and performance measures as well as trends and changes in financial statements. Current practice focuses discussion on changes in financial data.
- Management's analysis should address separately the performance of each business segment within a multisegment company in addition to the company as a whole. Companies should discuss the same business segments in MD&A as identified in the segment note in the financial statements.
- Management's analysis should focus as much on the future as on the past. Current practice often focuses on the past.
- Current guidance for MD&A asks companies to do too much in one place. For example, it asks companies to explain reasons for changes in historical data, discuss trends, and discuss events and uncertainties that would cause reported financial information not to be indicative of the future. The substance and quality of MD&A would be improved if management's analysis was divided into more manageable pieces, each with a particular focus. For example, the Committee's model breaks management's analysis into (1) reasons for changes in the financial, operating, and performance-related data and the identity and past effect of key trends, addressing the areas identified in the model (appendix II), (2) forward-looking information, as defined in the model (discussed below), and (3) broad objectives and strategies.

Forward-Looking Information

As used in this report, forward-looking information is in three categories:

1. Opportunities and risks, including those resulting from key trends.
2. Management's plans, including critical success factors.
3. Comparison of actual business performance to previously disclosed opportunities, risks, and management's plans.

Forecasted financial statements are not part of forward-looking information, as defined above, nor are those financial statements suggested by the Committee's model, for reasons discussed above under practical constraints.

Opportunities and risks are characterized as material trends, demands, commitments, concentrations, or events, including legal proceedings, known to management that would cause reported financial information not
to be indicative of future core earnings, net income, cash flows, or future financial condition. Opportunities and risks fall into the following classes:

- Opportunities and risks resulting from participation in additional industries.
- Opportunities and risks resulting from changes in a segment's industry structure (such as change in the intensity of competition and the bargaining power of customers or suppliers).
- Opportunities and risks that result from concentrations (for example, concentrations in assets, customers, or suppliers).
- Risk of illiquidity.
- Contingent gains and losses related to a company's rights and obligations, including legal proceedings.

The importance to users of understanding management's perspective on opportunities and risks was discussed in chapter 3. The SEC already requires, in MD&A, disclosures about opportunities and risks. For example, regulation S-K, item 303, paragraph 303(a) instruction 3, states:

The discussion and analysis shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition. This would include descriptions and amounts of (a) matters that would have an impact on future operations and have not had an impact in the past, and (b) matters that have had an impact in reported operations and are not expected to have an impact upon future operations.

Despite the current disclosure requirement, users believe disclosures about opportunities and risks should be improved. Including the disclosures in a separate section of a business report and providing a framework for identifying and disclosing information about opportunities and risks would improve the usefulness of the disclosure.

The model does not require management to discuss all opportunities and risks. Rather, it limits disclosures to opportunities and risks that meet five criteria:

1. Current exposure. The opportunity or risk should not develop wholly in the future.
2. Important concern. Importance is determined by the combination of three factors: likelihood of occurrence, magnitude of potential impact, and imminence of potential impact, as discussed in section III(A)4 of the model.
3. Specific or unusual exposure. The opportunity or risk should be different from the general opportunities and risks faced by most businesses, such as the risk of a recession.
4. Helps estimate cash flows or earnings.
5. Limited to opportunities and risks that have been identified and considered by management in the operation of the business.

Disclosures about opportunities and risks that meet the above criteria should include (1) the nature of the opportunity and risk and the identity of the trend, demand, commitment, or event that gives rise to it and (2) the effects, if any, on the company's future earnings and cash flows. The model suggests, in section III(A)3, specific disclosures related to liquidity.

The model also includes disclosures of management's plans, including critical success factors. As discussed in chapter 3, users find management's plans important in understanding where management intends to lead a company, which, in turn, is important in understanding a company's opportunities and risks.

The model suggests the following as a framework for disclosure about management's plans:

- Disclose management's plans to meet each of the broad objectives and business strategies (disclosed in the background section of the model) that management believes will affect cash flows significantly.
- Discuss the identity and importance of internal and external factors or conditions management believes must be present to meet its broad objectives and business strategy.
- Compare actual business performance with previously disclosed opportunities, risks, and
management's plans.

Companies are concerned that disclosures about management's plans could harm a company's competitive position significantly. However, as discussed under practical constraints, several factors mitigate the competitive costs of reporting management's plans. Further, the information often can be provided in a form that provides insight to users while not significantly harming competitive position. Further, companies need not disclose plans that would harm their competitive positions significantly.

**Background Information**

The model divides information in the background category into three elements: (1) broad objectives and strategies, (2) scope and description of business and properties, and (3) impact of industry structure on a company. Current practice already requires disclosures in the scope and description of business and properties category. The Committee's model for that type of information is substantially consistent with that practice. Current practice does not require information for the two remaining elements, although public companies often voluntarily discuss their objectives and strategies in business reporting.

Reporting under the model would include information about a company's broad objectives and business strategy. This information also could have been classified as forward-looking information, since objectives and strategy are, by their nature, forward-looking. However, the Committee included objectives and strategy in the background category because it is helpful to evaluate historical data in the context of what management was trying to achieve.

The model suggests that companies identify their broad objectives and the business strategies used to achieve each broad objective. The disclosures about business strategy should also discuss the consistency or inconsistency of the strategy with key trends affecting the business. That information helps users evaluate the degree to which a company's business strategy is aligned with the broader business environment.

The importance of an industry perspective in analyzing a business was discussed in chapter 3. Management is not necessarily the best source for information about the industry in which a company operates. However, management is the best source for information about how industry structure affects the business it manages. That impact should be the focus of the reporting.

The model provides a framework for reporting information about industry structure, which the Committee borrowed from the industry framework suggested by Michael Porter in his book, *Competitive Advantage*. More specifically, the model divides the discussion into four categories, listed in section IV(C) of the model:

1. Management's information about technological and regulatory changes that may affect a company's market through introductions by others of products or services that are superior to those offered by a company.
2. Information about the bargaining power of a company's resource providers, including employees, highlighting cases in which a company must rely on only one or a few suppliers, and the ability of those suppliers to dictate prices to a company.
3. Information about the bargaining power of a company's customers, including the extent to which business is dispersed among customers, and the ability of a company to dictate prices to its customers.
4. Information about the intensity of competition in an industry, focusing on the dispersion of competitors, and measures indicating the intensity of rivalry.

**Understanding Costs and Benefits**

**Recommendation 2**

*Improve understanding of costs and benefits of business reporting, recognizing that definitive quantification of costs and benefits is not possible.*

Improving the types of information in business reporting inevitably means facing difficult cost-benefit decisions. Unfortunately, despite the importance of those decisions, much of what is written is speculative, in part
because definitive quantification of costs and benefits is impossible. But progress can be made, through additional research and discussions with users and companies, in identifying the different types of costs and benefits, as well as their range and relationships. Progress in this area would facilitate deliberations and improve decision making about the types of information that should be included in business reporting.

The limitations of additional cost-benefit research should be borne in mind. First, important areas do not lend themselves to empirical research. Second, no amount of research is going to yield reliable dollar figures for the public and many of the private benefits and costs of disclosure. Third, because of the nature of social decision making, even assuming, for the sake of argument, that research could produce such dollar figures, the results could never relieve those who make recommendations on disclosure or those who set standards of the obligation to exercise judgment, make tradeoffs, consider the interests of all participants, and determine the public interest.

Kenneth J. Arrow, a Nobel laureate, demonstrated that ideal outcomes from collective decision making could never be a direct aggregation of constituent preferences. Therefore, even if every constituent's preferences were backed by indisputable cost-benefit figures, no decision for the group could directly reflect the rank ordering of the diverse preferences.

The FASB was rightly constituted to consider all points of view but to leave the decision to the deliberations of those selected for their expertise, ideals, and temperament. No group that considers informative disclosure can avoid the hard task of seeking the public interest. Cost-benefit research should never hide the responsibilities of those charged to improve business reporting.

Thus, with awareness of its limitations, the Committee encourages additional research and hopes that its analysis of the generic benefits and costs of disclosure, discussed in chapter 4, will help to stimulate it.

Below are examples of the types of research subjects that could improve understanding of the range and relationships of various types of costs and benefits:

- The types of information users need as inferred from:
  
  (a) Business and investment models.
  (b) Information that companies, investment bankers, and advisors gather to value companies that are candidates for acquisition.
  (c) Formal reports on companies from analysts, rating agencies, loan officers, and credit managers.
  (d) Information companies voluntarily supply to users, including when seeking capital at critical stages, such as initial start-up.

- The usefulness of various types of information in decision making, including the correlation between a type of information and the quality of user decisions.
- The correlation between types of information in business reporting and the value of disclosing companies or their securities prices.
- The correlation between types of information in business reporting and the average cost of capital for companies.
- Relative costs of developing and presenting various types of informative disclosure.
- The usefulness to competitors of disclosures designed to be informative to users, and the extent to which competitors are already aware of those disclosures.
- The correlation between informative disclosures and lawsuits and the extent to which informative disclosures help companies defend against lawsuits.

Footnotes

Chapter 6 — Financial Statements and Related Disclosures

Financial statements are at the center of business reporting. As discussed in chapter 3, the Committee’s study confirmed the importance of financial statements — they generally provide users with essential information that heavily influences their decisions. Despite the general vote of confidence, however, users were strongly critical about certain aspects of financial statements and they offered or supported many substantive ideas for improvement.

Those involved in business reporting long have appreciated the importance of financial statements and the need to keep them relevant. Standard setters, regulators, and many others devote considerable resources to maintaining and improving them. The FASB includes seven full-time board members, with a supporting staff of about forty. The AICPA establishes standards through part-time boards and supporting subcommittees and task forces, with full-time staff support. The SEC also sets standards for financial statements. Each of these organizations receives considerable help from companies, auditors, academics and, to a lesser extent, users through advisory boards, task forces, meetings, comment letters, public hearings, and field tests.

Despite the continuing effort to enhance financial reporting, changes in the environment constantly threaten the relevance of financial statements. For example, new reporting issues surface regularly because of changes in business transactions, new types of relationships between companies, new laws, and changes in the political, social, technological, and economic environments. Standard setters struggle to keep pace with changes to ensure that financial statements reflect the underlying economics of transactions and events and that reporting is comparable among companies.

Despite the backlog of new issues, standard setters spend much of their time reconsidering controversial provisions in existing accounting standards. Critics frequently assert that existing standards do not result in proper reporting, that practice has resulted in diverse reporting by companies, or that standards conflict with each other.

The Committee's focus on users should help, for at least three reasons. First, a user focus can help identify high-priority areas for improving business reporting, which, in turn, can help standard setters develop their agendas. A related but less apparent benefit is the insight a user focus provides into areas that are less important. Obviously, because standard-setting time is scarce, standard setters should defer considering low-priority issues. Third, a user focus can help identify specific ideas to improve financial statements and evaluate the pros and cons of possible improvements.

This chapter is organized in three sections. The first discusses the Committee’s recommendations to improve financial statements. The second identifies issues the Committee believes standard setters should defer considering because they have low priority. The third section identifies changes suggested by users that the Committee rejected because it judged the costs would exceed the benefits.

Recommendations to Improve Financial Statements

The Committee’s recommendations are based on both user criticism of current financial statements and the Committee’s understanding of users’ needs for information and ideas to better align financial reporting with those needs. The discussion identifies each recommendation, discusses why it is consistent with users’ needs for information, and explains why the information can be provided at acceptable cost.

The Committee’s recommendations necessarily are broader and less detailed than are accounting standards. Although the Committee believes it has sufficient basis to recommend its ideas to standard setters, the Committee has not followed a full due process approach, and further study of benefits and costs is necessary to convert the recommendations into specific accounting standards.

Recommendation 1

Improve disclosure of business segment information.
As discussed in chapter 3, for users analyzing a company involved in diverse businesses, financial information about business segments often is as important as information about the company as a whole. Users suggest that standard setters assign the highest priority to improving segment reporting because of its importance to their work and the perceived problems with current reporting of segment information.

The Committee considered three issues related to segment reporting: the basis of segmentation, that is, the kinds of segments that companies should report; the kinds of financial information companies should report about each segment; and the frequency of reporting that information. This section discusses the first two issues as well as investments in unconsolidated entities since users’ criticism of the reporting of these is similar to their criticism of segment reporting. Frequency of reporting is discussed later in the chapter under recommendation 6 on improving interim reporting.

**Basis of Segmentation**

The goal of segment reporting is to provide additional insight into the opportunities and risks a company faces. Thus, in concept, companies should determine the segments to be reported based on opportunities and risks: those activities having similar opportunities and risks should be aggregated while those having diverse opportunities and risks should be reported as separate segments. A company whose activities face similar opportunities and risks is not a multisegment company and would not report segment information.

There are many bases on which a company's activities may be segmented. They include industry; product lines; individual products; legal entities within the company; geographic based on where the company produces products or delivers services; geographic based on where the company sells its products or services; and others.

The Committee's study of users' needs indicated that industry segment information most frequently provides the greatest insight into the opportunities and risks a company faces. Segmentation based on geographic location also provides insight although it often is of less interest to users. Both bases of segmentation are widely accepted by users in practice. Other segments are useful in fewer circumstances or with fewer types of users, and the Committee believes the costs exceed the benefits of providing the information on those bases in general-purpose business reporting.

**Industry Segments**

FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise*, as amended, requires disclosures by industry segment. An industry segment under Statement 14 is defined as a grouping of similar types of products or services a company offers to outsiders. Users appear to be comfortable with that concept and definition of an industry segment.

Although they are comfortable with the concept of industry segments, users are troubled by its application in practice today. They believe that many companies define industry segments too broadly for business reporting and thus report on too few industry segments. As a result, users say, they are unable to evaluate opportunities and risks at a sufficient level of detail.

The Committee does not propose changes to the concept or definition of industry segment. Rather, in response to the users’ complaint, the Committee suggests that standard setters consider practical devices that will help companies better define their product and service groupings and, if appropriate, disclose information about more industry segments.

The Committee believes the primary means to improving industry segment reporting should be to align business reporting with internal reporting. That is, to the extent possible, companies should define industry segments for business reporting in a manner consistent with their definitions for internal reporting to senior management or the board of directors. The fact that a company defines industry segments more narrowly for internal reporting to senior management than it does for business reporting strongly suggests that it should expand the number of segments reported externally.

Many, if not most, companies manage their businesses and develop internal financial reports along industry lines. In devising internal reporting systems, diverse companies define business segments to provide
management and board members with insight into the company and its various businesses. On the one hand, information about every product or service within a diverse company is usually too detailed to provide much insight at the senior policy-making level. On the other hand, information about a diverse company as a whole is too aggregated. In-between those extremes is information about groups of related products and services on which senior management or board members choose to focus in analyzing a company's performance and managing and overseeing a company's operations. Users also would benefit from reporting on those segments because of the insight it would provide into a company's opportunities and risks.

Aligning business with internal reporting also is consistent with the objective of many users to understand management's perspective about the company it manages; this same theme is central to the Committee's model of business reporting. Users complain that companies too frequently cannot answer questions about segment data in business reporting because it is classified inconsistent with the segment data used internally. Users also complain that companies too often discuss business segments in MD&A that are not reported as separate business segments in the segment note in the financial statements. Aligning business with internal reporting would solve both problems. It also would provide users with insight into how management defines its businesses, which can indicate the direction in which management intends to take the company, provide insight into opportunities and risks, and reduce costs of preparing disclosures.

Some multi-industry companies choose to manage and report internally along a basis other than by industry. For example, some companies manage and report solely on a geographic basis. However, the fact that a multi-industry company chooses to manage itself geographically does not override the fact that it operates in multiple industries or that its activities in those industries are subject to different opportunities and risks. Thus, multisegment companies should report information about their industry segments even if they manage their businesses on a different basis.

In addition to aligning business with internal reporting, standard setters should consider the following practical devices that may help companies define their industry segments consistently with users' needs for information. In deciding on industry segments, companies should:

- Consider the way in which companies carry out their business activities. The fact that certain products or groups of products require different or specialized functions within a company suggests a company has multiple segments. For example, the fact that a dedicated marketing team supports one group of products but not others suggests that group may be a reportable segment.
- Consider how analysts attempt to segment a company in their published reports. If a company is not followed by analysts, it should look at the way analysts segment publicly held competitors that are followed by analysts.
- Consider the industry segment definition used by competitors. However, a company should not use the reporting practices of competitors to justify reporting fewer segments as that practice results in lowest-common-denominator reporting.
- Establish a cap of eight to ten industry segments. Reporting information about a larger number of segments probably is not worth the cost.

It is important to distinguish between industry segments and product line segments. Industry is a broader concept than product line and a far broader concept than individual products. With one exception, diverse companies should report information about industry segments and not about product lines or individual products. The exception is the unusual case in which a single product line or individual product is a critical cause of a company's opportunities and risks. In that case, a company should provide segment information for that product line or individual product.

**Geographic Segments**

Key trends (for example, political, sociological, regulatory, economic, and technological) vary widely from location to location. Thus, information based on the geographic areas where a company does business often provides important insight into a company's opportunities and risks resulting from those trends.

Two bases of geographic information may be helpful in assessing opportunities and risks. The first is where a company sells its products or services (market locations) and the second is where a company produces products or services (operating locations).
As discussed in chapter 3, the usefulness of geographic information depends on the company and its circumstances. The basis of geographic information, and the regions to be reported, can differ among companies and over time for the same company.

Because the usefulness of geographic segment information varies, the Committee recommends flexible standards. Those standards should:

- Require geographic segment information only when it provides insight into the opportunities and risks a company faces.
- Align geographic segment information reported externally with information reported internally to senior management or the board of directors, to the extent possible.
- Require that companies consider disclosing geographic segment information based on market locations or operating locations, or both, depending on which provide insight into opportunities and risks.
- Not specify the type of geographic areas to be reported. Rather, companies should define geographic segments in a manner that provides the most insight into opportunities and risks, which may result in segments smaller or larger than countries.
- Require that companies consider disclosing geographic information for each industry segment rather than geographic information for all of a company's activities in one location if the former method provides greater insight into the opportunities and risks for those industry segments.

The Committee's recommendations differ from the geographic segment requirements in Statement 14 in two respects. First, the Committee suggests that companies consider disclosing geographic information on two bases: operating locations and market locations. In contrast, Statement 14 requires geographic information based on operating locations and export sales from the company's Home country. As discussed above, segment information based on market locations often can provide considerable insight and should be disclosed when important. The Committee rejects disclosures about export sales because the information overlaps and is not as complete as segment information based on market locations.

Second, the Committee suggests that information about geographic regions within countries occasionally can provide particular insight and should be disclosed when important. In contrast, Statement 14 does not require disclosures for areas smaller than countries.

### Recommended Financial Disclosures About Segments

The Committee's recommendations regarding financial disclosures about segments are discussed under four headings: key statistics; limitation on the statistics to be reported; limitations on the types of companies reporting segment information; and other matters related to the types of segment information to be provided.

#### Key Statistics

In concept, users would like complete financial statements for each industry and geographic segment. However, as a practical matter, for the reasons discussed below under "The Costs of Reporting Segment Information," companies should be allowed to limit segment disclosures to key financial statistics.

The FASB adopted the key statistic approach. For example, for industry segments, Statement 14 requires that multisection companies report revenues, operating profit, identifiable assets, depreciation and amortization, capital expenditures, and equity income of investees. It also requires that for foreign operations, companies report revenues, a measure of profitability, and identifiable assets.

The Committee recommends that standard setters reconsider the key statistics to be reported for segments, including whether the statistics should vary by industry or sector. For example, it may be appropriate for financial institutions to report statistics that differ from those reported by manufacturing companies. In addition, standard setters should consider whether the key statistics should be expanded beyond those now required to include:

- Gross margin or some other statistic, to help users understand the segment's operating leverage.
• Cash-flow statistics, to assist users that focus on cash flows.
• Improved disclosure about the effects of unusual or non-recurring items, to help users identify core earnings or cash flows.
• Working capital, to help users understand a segment's need for capital.
• Research and development costs, to help users understand a segment's commitment and need to develop new products, services, or processes.
• Major classes of assets, such as receivables, inventories, and property, to help users assess the segment's need for capital and evaluate opportunities and risks.

In specifying the computation of the key statistics, standard setters should not require arbitrary allocations of revenues, expenses, assets, or liabilities. Rather, they should allow companies to report a statistic on the same basis it is reported for internal purposes, if the statistic is reported internally. The usefulness of information prepared only for business reporting is questionable. Users want to understand management's perspective on the company and the implications of key statistics. Management will be in the best position to address questions about the statistics if they are consistent with the information reported and used internally.

**Limitation on the Statistics to Be Reported**

The Committee recommends that key statistics to be reported be limited to statistics a company has available (with the exception of revenues and cost of revenues, as discussed below). This concept differs from Statement 14, which requires that companies report key statistics even if they have to develop new reporting to capture the information. A statistic is available to a company if it is used for internal reporting or if information already captured by the accounting system can be aggregated to develop the statistic.

Limiting the statistics reported to those that are available serves several objectives. First, it reduces costs of gathering, auditing, and reporting information, particularly for smaller multisegment companies. Second, it is more likely that management can respond effectively to questions from users about information it uses to manage the segment. Third, the fact that a company does not capture a particular statistic may suggest the statistic is not very relevant.

All multisegment companies should report at least the revenues and cost of revenues (for the manufacturing industry, and surrogate measures for other industries) related to their segments. Revenues and costs of revenues are so important to evaluating segment performance that reporting them is justified even if the information is not readily available. The Committee suspects, however, that this requirement would not impose a burden on most companies since they already capture this information.

**Limitation on the Types of Companies Reporting Segment Information**

Creditors prefer segment reporting requirements to be the same for public and non-public entities. Regardless of company size or ownership, operating in different industries or over varied geographic areas causes a company to face diverse opportunities and risks; information about industry or geographic segments helps users assess those opportunities and risks. Thus, the Committee recommends that segment reporting apply to all multisegment companies. This recommendation differs from Statement 14, which requires segment reporting only for multisegment public companies.

**Other Matters Related to the Types of Segment Information to Be Provided**

Statement 14 requires companies to report segment information in a format that reconciles each key statistic to the applicable consolidated total in the financial statements. Often, that reconciliation requires an "other" segment that includes businesses or geographic regions that individually do not meet the criteria for disclosure as separate segments. That requirement has provided users with useful information and should be continued. The Statement also requires that companies restate previously reported segment information to reflect changes in definitions of industry or geographic segments. Segment information should be restated if the restatement can be reasonably assembled and is necessary for a better and more complete understanding of the business. Otherwise, restatement or reclassification should not be required.

**The Costs of Reporting Segment Information**
The Committee is sensitive to the costs of segment reporting and has attempted to develop recommendations that could be met without inflicting significant costs on companies. Companies are concerned about the costs of accumulating, preparing, and auditing segment information and about the potential competitive costs of segment reporting. These costs are discussed below.

**Costs to Accumulate, Prepare, and Audit Segment Information**

Defining segments consistently for internal and business reporting, limiting the reported statistics to those available, not requiring arbitrary allocations, and reporting on geographic segments only when it provides insight about opportunities and risks reduce significantly the costs of accumulating, preparing, and auditing segment information.

Because smaller companies currently are exempt from reporting segment information, they are particularly concerned about the additional costs engendered by that reporting. The Committee believes that the vast majority of smaller companies operate in single industries or in narrow geographic regions and would not be subject to segment disclosure requirements. For smaller companies operating in diverse businesses or geographic locations, segment reporting would be limited to revenues, costs of revenues, and other key statistics available. That information could be provided at minimal cost.

The Committee's recommendations would result in some public companies reporting more industry segments than they report currently. However, the incremental costs to accumulate and prepare information about those segments should not be significant if business reporting is aligned with internal reporting as the Committee recommends.

**Competitive Costs**

Companies, particularly public companies, are concerned about the potential competitive costs of improved reporting of segment information. They are concerned that competitors will gain new insight from segment information and use that insight to the company's competitive disadvantage. To a lesser extent, companies are concerned that suppliers and customers also will gain new insights from better segment reporting, thereby enhancing their relative bargaining positions in price negotiations.

Three factors mitigate the competitive costs of segment reporting. First, companies already receive useful information about competitors from competitors' former employees, mutual suppliers and customers, market research, and the marketplace. The competitive cost of disclosing segment information depends on the incremental insight that information brings to competitors relative to their other information sources. Second, competitive costs are mitigated by the broad nature of segment reporting. The concept of an industry segment is broader than that of a line of business and far broader than that of individual products. Thus, industry segment reporting provides information that is not as useful to competitors as information about lines of business and individual products would be. Third, the insight competitors gain is at least partially offset by the insight a company gains from its competitors' segment information.

Many public companies are concerned about the unfair advantage of foreign competitors that raise capital in their local markets and, under their local reporting requirements, do not disclose segment information. Some U.S. companies argue for leveling the playing field by allowing U.S. companies to report fewer segments or less segment information. That solution, however, would itself tilt the playing field in favor of U.S. multisegment companies, which still would have access to the complete reporting of their single-segment, public company competitors. The Committee does not recommend eliminating segment reporting because of its usefulness and because of the unlevel playing field it would create for U.S. companies. The playing field with foreign competitors should be leveled by harmonizing reporting standards in a manner that meets users' needs for information, not by reducing the quality of U.S. reporting.

As discussed in chapter 5, the Committee recommends that management should not be required to report information that would harm a company's competitive position significantly. That constraint should apply to reporting segment information. However, if competitive costs are significant, a company should not report fewer segments. For example, a multisegment company should not suggest that it is in one industry. Rather, it should omit only the particular types of information that are competitively harmful, while disclosing the remainder.
**Litigation Costs Are Not an Issue**

Companies did not raise litigation costs as a significant factor in improving segment reporting. Segment information usually is derived from the same accounting records as those used to prepare the company's financial statements. Thus, management should be comfortable with the source and reliability of the information, particularly if it is aligned with internal reporting, as the Committee suggests. Further, unlike other types of data such as forward-looking information, segment information does not appear to be a troublesome source of litigation.

**Investments in Unconsolidated Entities**

Users want to understand and analyze significant investments in unconsolidated entities (investees) for the same reasons they want to analyze segments: separate analysis of an investee provides insight into opportunities and risks that aggregated reporting cannot achieve. Investees include non-controlling investments by one company in another company, partnership, or joint venture. The frequency and magnitude of those investments are increasing as companies seek to take advantage of new technology or market opportunities while sharing risks with others.

Many investments in investees are accounted for by the equity method. Under that method, the investment is reported in the balance sheet of the investor as a single amount. Likewise, an investor’s share of earnings or losses from its investment usually is reported in the income statement as a single amount. In most cases, additional information about an investee’s results of operations and financial position is provided in notes to the investor's financial statements.

There are two alternatives to the equity method of accounting for recognizing investments in investees: proportionate consolidation and expanded equity methods. Under the proportionate consolidation method, an investor would record its proportionate interest in the investee’s assets, liabilities, revenues, and expenses on a line-by-line basis and combine the amounts with its own assets, liabilities, revenues, and expenses. For example, if an investor owns 30 percent of an incorporated joint venture, 30 percent of the joint venture's cash balance would be added to the investor's cash balance; 30 percent of the investee’s other assets, liabilities, revenues, and expenses would be handled similarly.

Under the expanded equity method, an investor's share in the total current and non-current assets and liabilities and in the total revenues and expenses would be displayed separately from the investor's other assets, liabilities, revenues, and expenses in the investor's financial statements and labeled descriptively, such as, "current assets of investee." Total assets of the investor would include the combined total of investee's and investor's financial items. This reporting method is a compromise between the one-line display under the equity method and the combined display of an investor's and investee's assets, liabilities, revenues, and expenses required under the proportionate consolidation method.

Users reject the proportionate consolidation method for accounting for investees because it combines amounts users seek to disaggregate. Users want to understand the opportunities and risks of significant investees as separate entities, much as they want to evaluate business segments separately. Combining amounts related to investors and investees reduces users’ ability to focus on investees’ operations. Worse, amounts related to investees can distort trends and relationships related to the investors’ operations. Thus, users fear the proportionate consolidation method would result in a loss of important information.

Users prefer either the equity or expanded equity methods, with no strong preference, provided there is adequate disclosure of information about significant investees. Disclosure is key.

Users complain that companies too often do not report enough information about investees. Consistent with their views on segment information, they recommend more disclosure about individual investees, particularly if those entities are important to the reporting company's earnings, cash flows, opportunities, or risks.

Many users would prefer to receive full financial statements for all investees or, at least, each significant investee, and would define significant using a 10 percent criterion rather than the SEC’s 20 percent criterion (rule 3-09 of regulation S-X). Some users support full financial statements for significant investees using the 20 percent criterion in deference to cost-benefit considerations. Users believe that it is more important to get more
information about each significant investee than aggregate information for insignificant investees. They are concerned that aggregated information for investees is not helpful because it combines entities having diverse opportunities and risks.

The Committee recommends the following concerning the accounting and disclosure of information about unconsolidated investees:

- The equity method of accounting should be retained because alternative methods are not better.
- The notes to the financial statements should include more information about unconsolidated investees in general and significant investees in particular. The SEC should consider lowering its threshold test for determining which investees are deemed significant.
- The need for information about investees is similar to the need for information about segments. Although users would like complete financial statements for each significant investee, companies should, as a practical matter, be able to limit disclosures to those required for industry segments.

FASB Projects on Disaggregated Disclosures and Unconsolidated Entities

The FASB currently is reconsidering the requirements of Statement 14 in a major project on disaggregated disclosures. Two aspects of this project are particularly positive: a user focus and involvement of other standard setters.

The project began with *Reporting Disaggregated Information*, a research report issued in February 1993, which, among other matters, summarized research about users' needs for segment information. The board also is studying the Committee's work on users' needs for segment information and has held several meetings with analysts and companies on the issue of how industry segments should be defined. The board intends to seek additional user input in the future.

The board is conducting the project jointly with the Accounting Standards Board of the Canadian Institute of Chartered Accountants (CICA) in an unprecedented effort to develop a parallel standard. Further, the International Accounting Standards Committee's (IASC's) agenda also includes a project on segment reporting, and the FASB, the CICA, and the IASC are exchanging information as their respective projects progress.

The Committee is pleased that the FASB has recognized the importance of improving segment reporting, is basing its decisions on research with users, and is coordinating its work with other standard setters. Coordinated efforts that focus on the information needs of users offer the best chance for harmonizing standards in a useful way.

The FASB's project on unconsolidated entities is not currently active, although the board plans to resume work on it in the future. The project will address presentation in the investor's financial statements of investments in non-controlled entities, including joint ventures and undivided interests.

The Committee recommends that the project's scope include disclosures about investments in unconsolidated entities as well as the accounting for those investments. Those disclosures should focus on financial information about each significant unconsolidated entity. The FASB also should consider disclosures of qualitative information, such as the business reason for the investment and the nature of dealings between the investee and investor. In addition to considering investments in equity securities, the scope of the project should include all significant interentity affiliations resulting from contractual arrangements or other such situations.

**Recommendation 2**

*Address the disclosures and accounting for innovative financial instruments.*

In recent years, there has been an explosion of innovative financial instruments such as swaps, swaptions, embedded options, compound options, caps, floors, collars, and many others. That explosion is likely to continue because the underlying causes — increased volatility and the need to manage risks related to that
volatility, increased competition, and advances in techniques for analysis and information technology — are likely to continue.

Accounting standards have not kept pace with the proliferation of innovative instruments. As a result, users are confused. They complain that business reporting is not answering important questions, such as: What is the company's goal in using innovative financial instruments, and how is the company going about achieving that goal? What instruments has the company entered into, and what are their terms? How has the company accounted for those instruments, and how has that accounting affected the financial statements? What risks has the company transferred or taken on? If the company has hedged certain risks, what are the related transactions or events hedged and when are they expected to occur?

Many of the above questions can be addressed through improved disclosure. However, users also are concerned about whether the accounting for innovative financial instruments reflects the underlying economics of those instruments. Those concerns raise fundamental accounting questions, such as: When should financial instruments be recognized in financial statements, and when should financial assets or liabilities be considered sold or settled? In what circumstances should financial instruments be measured at historical cost, market value, lower of cost or market, or some other basis? How should financial instruments that consist of both liability and equity elements be treated? What special accounting, if any, is appropriate for hedging activities?

To date, accounting guidance has focused on specific innovative financial instruments and conditions. For example, the FASB Emerging Issues Task Force (EITF) has dealt with sixty-one issues on financial instruments, many involving innovative instruments, the largest category of issues the EITF has addressed. Although the EITF's work has been important and has filled a void in guidance, an instrument-by-instrument approach offers little hope of addressing the fundamental questions that need to be addressed. Further, it always will lag behind the pace of innovation in financial instruments. What is needed is broader guidance that addresses fundamental issues. That guidance would provide a framework for addressing the accounting for future innovations in financial instruments, thereby leading rather than lagging behind the pace of change.

The FASB appreciates the need for broader guidance. Since 1986 the board's agenda has included major projects on financial instruments, with the ambitious goal of creating a broad framework that addresses fundamental issues. To date, standards have focused on disclosures, which, as indicated by the first set of questions, are important. It also has issued documents addressing recognition and measurement issues, including three statements, an interpretation, two discussion memoranda, and various research reports. Several projects on financial instruments currently are active and more projects are waiting in the wings for a spot on the agenda. A considerable portion of the board's staff is devoted to projects involving financial instruments.

The Committee's work with users affirmed the critical importance of improving disclosures and accounting for innovative financial instruments, thereby confirming that the FASB is addressing the appropriate issues and is right in giving that work the highest priority.

**Recommendation 3**

**Improve disclosures about the identity, opportunities, and risks of off-balance-sheet financing arrangements and reconsider the accounting for those arrangements.**

Users are concerned that they do not understand the risks resulting from certain transactions and arrangements that, under current accounting rules, are not reflected on the balance sheet. Those transactions and arrangements sometimes involve long-term leases, unconsolidated and special purpose entities, and securitizations, to cite a few examples. The following discussion describes those transactions or arrangements, reasons for the users' concern, the FASB's projects addressing off-balance-sheet financing arrangements, and the Committee's recommendations.

**Long-Term Leases**

Some users believe all leases convey both property rights and obligations that should be recognized as assets and liabilities on the lessee's balance sheet. Thus, they would eliminate the distinction between operating and capital leases and capitalize all leases. The AIMR holds that view and would extend the concept to recognize in financial statements the rights and obligations in all executory contracts.
Other users see a fundamental distinction between leases that convey the rights and obligations of property ownership and those that are executory, representing the rental of property. They argue that the distinction between operating and capital leases should be retained. Some users within this group generally are pleased with the current criteria used to distinguish operating and capital leases. Others would change the criteria in one manner or another to, for example, classify more leases as capital leases.

Regardless of their views on the accounting for leases, most users would expand disclosures related to operating leases. Current disclosures, they believe, are not adequate to allow users to understand the opportunities, risks, and obligations that result from the company's leasing contracts. To provide more insight they suggest, for example, that companies:

- Separately disclose information about lease obligations grouped by major type of asset leased rather than disclose only aggregated information for all operating leases.
- Separately disclose information about lease obligations grouped by lease term, such as short-term, medium-term, and long-term.
- Disclose the present value of minimum lease payments.
- Distinguish lease obligations by separating obligations representing inescapable future cash payments from obligations that would extend only a limited time regardless of the specified lease term (for example, in bankruptcy).

**Unconsolidated and Special Purpose Entities**

Companies maintain significant but non-controlling ownership interests in other entities (unconsolidated entities) for many reasons. For example, a company may want to share financial and market risks with others in joint ventures, access new technology, or enter foreign markets that require local company control.

Some companies also are motivated to structure investments in unconsolidated entities to finance assets or operations without recognizing the associated debt on their balance sheets. Because companies do not control unconsolidated entities, they recognize their net investment as a single asset and do not record the entities' separate assets and liabilities.

Companies that structure investments in unconsolidated entities primarily to achieve off-balance-sheet treatment often want to retain as many benefits of complete ownership of the entities as possible without triggering consolidation. For example, a company may manage the unconsolidated entity or agree to purchase a large portion of the products or services the entity provides. At the same time, the parties providing the financing for the entity may want the company to retain as much of the risk as possible concerning the entity's debt and may require, for example, that the company guarantee the debt.

One popular structure involves the use of special purpose entities (SPE) whereby a company (the sponsor) forms a new company (the SPE) that will operate primarily for the benefit of its sponsor. Usually the SPE is highly leveraged and capitalized with minimal equity. The sponsor retains most of the opportunities and risks related to the SPE even though it may own little or none of the SPE's equity.

Retaining most but not all of the risks and rewards of ownership over the unconsolidated entity raises fundamental questions about the circumstances in which one company should consolidate another. Users are concerned that current rules may permit companies to exclude from their balance sheets rights and obligations that make companies appear to be less risky than they are. Other users do not propose changes to the criteria for consolidation but suggest the need for expanded disclosures about unconsolidated entities — disclosures that allow users to understand the opportunities and risks resulting from a company's investment in an unconsolidated entity and its contractual ties to that entity. Some users would like enough information to judge whether the unconsolidated entity should be consolidated for purposes of their analysis and, if so, to prepare approximate pro forma statements to reflect that consolidation.

**Securitizations**

Securitizations involve the sale of assets, usually financial assets such as receivables, to a trust that then issues securities to investors. The cash flows to the security holders are determined by the cash inflows from the assets in the trust. Securitizations have become popular in recent years and have expanded both in terms
of value and in the types of financial assets that are securitized. They have opened new ways for companies to sell financial assets and have offered investors a diverse range of securities tied to various portions of the cash flows from the trust.

Companies that sell financial assets to be securitized and that have no continuing involvement with them raise few accounting issues. However, in some cases, companies retain risks and rewards associated with ownership of the assets. For example, companies may continue to service the financial assets in the trust or guarantee that the credit losses related to the assets will not exceed a certain amount.

A company’s continuing involvement with the assets in the trust raises fundamental questions about the substance of the securitization transaction. Did the company sell assets or did it obtain financing secured by the assets? Current rules usually allow companies to record the transfer of assets in a securitization as a sale. Some users are concerned that some forms of continuing involvement with the assets are inconsistent with recording sales. Other users are not concerned about the current accounting for securitizations. However, most users would prefer more disclosure about the continuing involvement of companies with assets that have been securitized and risks related to that involvement.

**FASB Projects Addressing Off-Balance-Sheet Financing Arrangements and the Committee's Recommendations**

The FASB's agenda includes projects addressing unconsolidated entities, special purpose entities, and securitization transactions. The scope of those projects includes both accounting and disclosures.

The Committee’s research with users affirmed the importance of providing accounting guidance for commonly used off-balance-sheet financing arrangements. However, due to time and resource limitations, the Committee did not develop recommendations related to accounting for unconsolidated entities, special purpose entities, and securitizations.

Users emphasized the importance of improving disclosures related to off-balance-sheet financing arrangements. Better disclosure would provide insight into the opportunities and risks of those arrangements that accounting alone cannot provide. Better disclosure also would permit users to calculate pro forma adjustments to the financial statements to reflect their own views about accounting for off-balance-sheet financing arrangements. The Committee encourages the FASB to emphasize disclosures in its projects on unconsolidated entities, special purpose entities, and securitizations.

The Committee does not recommend that the FASB reconsider the accounting for leases at this time. Users are divided about the best accounting and for users that choose to do so, improved disclosures could provide enough information to determine the effect of capitalizing all leases. Because of the importance of disclosures, the Committee recommends that the FASB add a limited-scope project to its agenda to improve disclosures by lessees of operating leases.

**Recommendation 4**

*Report separately the effects of core and non-core activities and events, and measure at fair value non-core assets and liabilities.*

The display of information on the face of financial statements offers a powerful tool in assisting users with their analysis. Financial statements do not display only net income, total assets, total liabilities, or net cash provided by operations. Rather, each statement includes key components within those totals designed to:

- **Depict transactions and events, in financial terms.** The income statement maps, through a separate display of items, a company's activities such as selling product (revenues), incurring costs directly related to those sales (cost of revenues), and incurring expenses that generally support the business (selling, general and administrative expenses). Similarly, the balance sheet displays separately amounts for the various types of assets and liabilities that companies own and incur, and the cash-flow statement displays separately cash flows related to operations, investing, and financing activities. Financial statements serve users as a model of a company's business and provide considerable insight into the relationships between transactions and events and the financial impact of those
transactions and events on the company — a key goal of financial analysis. In general, the closer the display in financial statements maps transactions and events, the more insight it provides.

- **Distinguish between the financial effects of a company's major or central operations and those of peripheral or incidental activities.** In general, the upper portion of the income statement relates to operations (such as revenues; cost of revenues; selling, general, and administrative expenses) and the lower portion relates to peripheral or incidental activities (such as non-operating gains and losses). Distinguishing between the financial effects of a company's major or central operations and those of other activities or events allows users to analyze trends affecting the business without the potentially distortive effects of peripheral or incidental activities.

- **Distinguish between the financial effects of a company's usual or recurring activities and those of unusual or non-recurring transactions and events.** The income statement separately discloses the effects of certain unusual or non-recurring items, including income from a discontinued segment of the business, extraordinary items, and the effect of a change in accounting principle. Assets and liabilities of discontinued segments are displayed separately on the balance sheet. Distinguishing between the financial effects of a company's usual or recurring activities and those of other activities improves the analysis of underlying trends and relationships in a company's ongoing businesses.

Users believe that financial statements and related disclosures do not contain sufficient information about unusual or non-recurring items to meet users' needs for information. The information is insufficient because the statements do not identify a sufficiently broad range of unusual or non-recurring items. Further, the descriptions and details of items labeled as unusual or non-recurring are sometimes insufficient to permit users to evaluate whether, for analytical purposes, to exclude the effects of the items from recurring operations.

Without adequate information about the effects of unusual or non-recurring items, users fear they will develop misleading impressions about key trends in the financial data (see exhibit 1). For example, the revenues and gross margin resulting from a one-time unusually large sale, if not separately disclosed, could create a misleading impression about the trends in market share, revenue, and income. Because users often apply a multiple to their estimates of a company's earnings or cash flows in valuing companies, misleading impressions about a key trend, or the sustainability of a company's earnings, can magnify an error in valuation.

The Committee believes that information about unusual or non-recurring transactions and events should be improved. Although there are various ways to provide improved information, the Committee believes that improved display of information on the financial statements, coupled with improved disclosure, offers a powerful tool to improve users' understanding of unusual or non-recurring transactions or events. More specifically, the financial statements should distinguish between the effects of core and non-core activities and events, and the related footnotes should include disclosures about the effects of non-core items.
Core and Non-Core Activities

The goal of distinguishing, on the financial statements, between the effects of core and non-core activities is to present the best possible information with which to discern trends in a company's business. A company's core activities are usual or recurring activities, transactions, and events. Usual means the activity is ordinary and typical for a particular company. Recurring means the activity, transaction, or event is expected to occur again after an interval. Core activities include usual or recurring operations and recurring non-operating gains and losses.

Conversely, non-core activities, transactions, and events are unusual (not typical for a particular company) or non-recurring (not expected to occur again in the foreseeable future or before a specified interval). Examples include:

- Discontinued operations (businesses that management intends to discontinue or abandon).
- Unusually large transactions that are not expected to recur in the foreseeable future.
- The effects of a rare natural disaster.
- Unique transactions, such as selling real estate by a company that rarely sells real estate.
- The effects of changes in accounting principles.

It can be presumed that all operations of a company are core activities unless considered otherwise by management.

Current practice already distinguishes between the effects of continuing operations, discontinued operations, and changes in accounting principles. Further, the concept of separately displaying unusual or non-recurring transactions or events (termed extraordinary items) is also in authoritative guidance. However, that concept has been interpreted so narrowly in practice that few transactions or events qualify as extraordinary. Users would be served better by broadening the concept of unusual or non-recurring transactions or events.

The term core activities sometimes is used in the business community to mean major, critical, or central operations as opposed to peripheral or incidental operations. However, based on discussions with users, the Committee uses the term core differently, as described above. The Committee believes that insight into different business activities, such as a company's main business and its emerging business, is best provided through segment reporting and not through display of information on the face of the financial statements.

The Committee considered whether disclosures about unusual or non-recurring items should be part of the financial statements or part of another element of the Committee's model, such as the management's analysis element. The Committee decided they should be in the financial statement element for the following reasons:

- Financial statements should present financial data in a form that facilitates an understanding of the business and trends affecting the business. Distinguishing between core and non-core items helps achieve that objective and is necessary to avoid potentially misleading impressions about trends affecting the business.
- The goal of management's analysis should be to identify and discuss the effects of trends. It is not to present adjustments to the financial data that are necessary to ready the data for analysis.
- Many companies will only report on and users will only receive the financial statement element. Thus, that element should be as helpful to users as possible by presenting data in a format that facilitates analysis.

Distinguishing between the effects of core and non-core activities would affect display on the income statement, statement of cash flows, and balance sheet, as described below.

Income Statement

Core earnings are not a prediction of future earnings. Rather, they are historical earnings adjusted to exclude the effects of historical unusual or non-recurring items. The goal of presenting core earnings is not to present
an estimate of normal income or recurring income. Neither should core earnings be averaged or smoothed artificially. The core earnings of a business that is inherently cyclical or volatile should appear cyclical or volatile — not smooth.

Exhibit 2 illustrates the changes that would be required in current practice to distinguish between core and non-core earnings:

<table>
<thead>
<tr>
<th>Current Practice</th>
<th>With Core/Non-Core Concept</th>
</tr>
</thead>
<tbody>
<tr>
<td>**Revenue ***</td>
<td><strong>Revenue</strong></td>
</tr>
<tr>
<td>**Cost of revenue ***</td>
<td><strong>Cost of revenue</strong></td>
</tr>
<tr>
<td><strong>Gross margin</strong></td>
<td><strong>Gross margin</strong></td>
</tr>
<tr>
<td>Selling, general, and administrative expenses *</td>
<td>Selling and marketing</td>
</tr>
<tr>
<td>Operating income</td>
<td>Research and development</td>
</tr>
<tr>
<td>Interest expense</td>
<td>General and administrative</td>
</tr>
<tr>
<td>Non-operating gains *</td>
<td>Other operating costs and expenses</td>
</tr>
<tr>
<td>Non-operating losses *</td>
<td>Recurring non-operating gains and losses</td>
</tr>
<tr>
<td>Pre-tax income from continuing operations</td>
<td>Pre-tax core earnings</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>Income taxes related to core earnings</td>
</tr>
<tr>
<td>Income from continuing operations before extraordinary item and change in accounting principle</td>
<td>Core earnings</td>
</tr>
<tr>
<td>of the business</td>
<td>Non-core items and financing costs:</td>
</tr>
<tr>
<td>Income before extraordinary item and cumulative effect of change in accounting principle</td>
<td>Financing costs (e.g., interest income and expense and gains and losses from settlement of debt)</td>
</tr>
<tr>
<td>Extraordinary item</td>
<td>Income (loss) from unusual or non-recurring transactions and events</td>
</tr>
<tr>
<td>Effect of change in accounting principle</td>
<td>Income (loss) from discontinued operations</td>
</tr>
<tr>
<td><strong>Net income</strong></td>
<td>Effect of change in accounting principle</td>
</tr>
<tr>
<td>Share data:</td>
<td>Pre-tax non-core income and financing costs</td>
</tr>
<tr>
<td>Income from continuing operations</td>
<td>Income taxes related to non-core items and financing costs</td>
</tr>
<tr>
<td>Income before extraordinary item in accounting</td>
<td>Non-core income and financing costs</td>
</tr>
<tr>
<td>Net income</td>
<td>Net income</td>
</tr>
<tr>
<td>Weighted average shares outstanding</td>
<td>Share data:</td>
</tr>
<tr>
<td>Core earnings</td>
<td>Non-core income and financing costs</td>
</tr>
</tbody>
</table>
• The statement would present two categories of earnings in the following order: core earnings and non-core items and financing costs.

• Interest income and expense would be relocated from a component of pre-tax income to the section below core earnings under financing costs. Similarly, gains and losses from extinguishment of debt would be relocated from extraordinary items to a component of financing costs and would be disclosed separately. The Committee is not suggesting that financing costs are non-core. Rather, it is suggesting that financing costs should be displayed in the "non-core items and financing costs" category in the income statement. Users prefer to analyze most businesses separately from the manner in which they are financed, and separating financing costs from pre-tax income is consistent with that approach. However, certain businesses, such as certain financial services, may need to report financing costs together with operations because it is difficult or impossible to distinguish between operating and financing activities.

• The effects of unusual or non-recurring transactions and events would be displayed separately as a component of non-core income. Amounts in the unusual or non-recurring category would be reclassified from revenues, expenses, gains, and losses.

• Discontinued operations is defined in current practice as a component of a company whose activities represent a separate major line of business or class of customer. That definition would be broadened to include all significant discontinued operations whose assets and results of operations and activities can be distinguished physically and operationally and for business reporting purposes.

• Extraordinary items would be eliminated. The concept is too narrow to be useful and is redundant with the unusual or non-recurring category. Items classified as extraordinary would be classified in unusual or non-recurring transactions and events or, if related to debt, financing costs.

• At a minimum, public companies would provide share data related to core earnings, non-core income and financing costs, and net income. Other share data also may be provided.

Nearly all users were intrigued with the concept of core earnings. Users agreed with the importance of providing more information about unusual or non-recurring items. Further, many adjust a company's reported income using a concept similar to core earnings to identify better trends in the business. Thus, the concept of core earnings appears to parallel the users' own thought processes.

Nevertheless, some users are reluctant to support a separate display of core earnings. They believe that determining core earnings is the role of financial analysis and not financial accounting. Further, they are concerned that the concept is vaguely defined and will result in non-comparable reporting in practice.

The Committee agrees that the ultimate judge of core earnings is financial analysis. However, the Committee does not propose the display of core earnings to replace user judgment. Rather, it proposes the concept as a means of providing a framework and discipline to present data that are useful to users in forming their own judgments about a company's core earnings and about unusual or non-recurring items. Note disclosures about the individual items in the non-core category should be designed to allow users to decide for themselves whether a particular item should be included in or excluded from core earnings.

The Committee acknowledges that two people looking at the same facts may reach different conclusions about
the best measure of core earnings. However, management is in the best position to identify unusual or non-recurring items, and users would benefit from that insight. Further, users will make judgments about the effects of unusual or non-recurring items regardless of whether business reporting discloses information about those items. Better disclosures about unusual or non-recurring items allow users to make better judgments.

Many preparers with whom the Committee spoke also were concerned about distinguishing between core and non-core items. Although they generally were intrigued by the concept, many considered the concept to be impractical. They noted that managers within their companies have spent a lot of time discussing the best measure of core earnings, often without agreement. Some companies even have concluded that nothing that affects their business is unusual or non-recurring.

The fact that many companies spend considerable time identifying core earnings underscores the analytical importance of identifying unusual or non-recurring items that have affected the business. For public companies, the SEC already requires management to describe unusual or non-recurring events or transactions and to quantify their effect in MD&A. The Committee's recommendations about core earnings provide a framework for thinking about and reporting disclosures that are already required.

**Statement of Cash Flows**

Exhibit 3 illustrates the changes that would be required in current practice to distinguish between core and non-core cash flows:

<table>
<thead>
<tr>
<th>Current Practice</th>
<th>With Core/Non-Core Concept</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cash Flows From Operating Activities</strong></td>
<td><strong>Cash Flows From Operating Activities</strong></td>
</tr>
<tr>
<td>Net income</td>
<td>Core:</td>
</tr>
<tr>
<td>Adjustments to reconcile to net cash provided by operating activities</td>
<td>Core earnings</td>
</tr>
<tr>
<td>Depreciation and amortization (other adjustments listed here)</td>
<td>Adjustments to reconcile to net cash provided by core activities</td>
</tr>
<tr>
<td></td>
<td>Depreciation and amortization (other adjustments listed here)</td>
</tr>
<tr>
<td></td>
<td>Net cash provided by core activities</td>
</tr>
<tr>
<td><strong>Net cash provided by operating activities</strong></td>
<td><strong>Non-core and financing costs:</strong></td>
</tr>
<tr>
<td></td>
<td>Non-core income and financing costs</td>
</tr>
<tr>
<td></td>
<td>Adjustments to reconcile to net cash provided by non-core activities and financing costs (adjustments listed here)</td>
</tr>
<tr>
<td></td>
<td>Net cash provided by non-core activities and financing costs</td>
</tr>
<tr>
<td></td>
<td><strong>Net cash provided by operating activities</strong></td>
</tr>
<tr>
<td></td>
<td>The investing and financing portions of the cash flow statement would be unchanged</td>
</tr>
</tbody>
</table>

- The cash flows from the operating activities portion of the cash-flow statement would present
two categories of cash flows in the following order: (1) core and (2) non-core and financing costs.

- Net cash flows from core activities plus cash flows from non-core activities and financing costs would equal net cash provided by operating activities.
- In concept, the investing and financing portions of the cash-flow statement also could separately display core and non-core cash flows. However, the incremental insight from changing, on a comprehensive basis, the investing and financing portions of the cash-flow statement would not justify the increased complexity of display and cost of preparing the information.

In valuing companies, users convert many measures into per share amounts, including earnings per share and operating cash flow per share. No single measure is universally accepted or sufficient. Consistent with various measures computed and used in practice, the Committee’s model permits disclosure of cash flow per share data, including core cash flow per share. In contrast, current guidance prohibits reporting cash flow per share data in financial statements and discourages reporting the data outside of financial statements, such as in MD&A.

**Balance Sheet**

Exhibit 4 (p. 86) illustrates the changes that would be required in current practice to distinguish between core assets and liabilities and non-core assets and liabilities.

<table>
<thead>
<tr>
<th>Current Practice</th>
<th>With Core/Non-Core Concept</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current assets</strong></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>Cash</td>
</tr>
<tr>
<td>Accounts receivable, net</td>
<td>Accounts receivable, net</td>
</tr>
<tr>
<td>Inventories, net</td>
<td>Inventories, net</td>
</tr>
<tr>
<td>Deferred tax assets</td>
<td>Deferred tax assets</td>
</tr>
<tr>
<td>Other current assets</td>
<td>Other core current assets</td>
</tr>
<tr>
<td></td>
<td>Non-core current assets</td>
</tr>
<tr>
<td></td>
<td>(measured at value)</td>
</tr>
<tr>
<td><strong>Current assets</strong></td>
<td></td>
</tr>
<tr>
<td>Property, plant, and equipment</td>
<td>Property, plant, and equipment</td>
</tr>
<tr>
<td>Other long term assets</td>
<td>Other long term assets</td>
</tr>
<tr>
<td></td>
<td>Long-term non-core assets</td>
</tr>
<tr>
<td></td>
<td>(measured at value)</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td></td>
</tr>
<tr>
<td>Current liabilities:</td>
<td>Current liabilities:</td>
</tr>
<tr>
<td>Accounts payable and accrued liabilities</td>
<td>Accounts payable and accrued liabilities</td>
</tr>
<tr>
<td>Income tax payable</td>
<td>Income tax payable</td>
</tr>
<tr>
<td>Current portion of debt</td>
<td>Current portion of debt</td>
</tr>
<tr>
<td></td>
<td>Non-core current liabilities</td>
</tr>
<tr>
<td></td>
<td>(measured at value)</td>
</tr>
<tr>
<td><strong>Current liabilities</strong></td>
<td>Current liabilities</td>
</tr>
</tbody>
</table>
The display would help users:

- Identify key trends in the financial position of a company's continuing operations without the potential distortive effects of unusual or non-recurring transactions or events.
- Consider core and non-core assets and liabilities separately when valuing a company or assessing a company's opportunities and risks.

Core assets and liabilities result from a company's usual or recurring activities, transactions, and events. Conversely, non-core assets and liabilities result from unusual or non-recurring activities, transactions, and events.

For example, non-core assets include:

(a) A receivable related to an unusually large sale of a product that is not expected to recur in the foreseeable future.
(b) Real estate held for investment by a company that only rarely invests in real estate.

Examples of non-core liabilities include:

(a) Liabilities that are closely associated with non-core assets, such as mortgage liabilities related to non-core real estate.
(b) A contingent liability related to a discontinued operation.

**Measuring Non-Core Assets and Liabilities at Fair Value**

The current model for measuring core assets and liabilities should be retained. However, for the reasons described below, non-core assets and liabilities should be measured at fair value. Further, changes in unrealized appreciation or depreciation in those assets or liabilities should be charged or credited directly to shareholders' equity.

The fair value of non-core assets or liabilities is directly relevant to many users that value companies using the following general formula. Those users usually follow fundamental approaches and often apply the formula segment-by-segment.

\[
\text{Value of a company's (segment's) continuing operations} \\
= \text{Value of company's equity} \\
\]
basis of historical costs) or cash flow usually does not depend on knowing the fair value of the individual assets or liabilities of the business. Thus, fair value is often down the list of users’ needs for information.

The value of non-core assets is not in their use in the business but in their ultimate sale. Thus, the fair value of those assets is most relevant to users. In the case of discontinued operations, the asset being held for sale is the business itself. The fair value of that business is the best indicator of the cash flows that will result from its sale.

The Committee also recommends that changes in unrealized appreciation or depreciation of non-core assets or liabilities should be charged or credited directly to shareholders’ equity. First, the earnings from non-core assets are not particularly important to users in valuing the ongoing operations. Users do not apply a multiple to that income because it is, by definition, random or does not relate to continuing operations. Second, users believe that recognizing the unrealized appreciation or depreciation would introduce noise in the income statement that would not be helpful in predicting future earnings or cash flows from continuing operations or in valuing non-core assets or liabilities.

To help users understand and evaluate the measurement of non-core assets and liabilities, companies should disclose the historical cost, fair values, and methods and assumptions used in determining the fair values of non-core assets and liabilities.

**Recommendation 5**

**Improve disclosures about the uncertainty of measurements of certain assets and liabilities.**

Under the current accounting model, all assets and liabilities must be measured and reported at an exact amount. There is little on the balance sheet or income statement indicating the relative precision of measurements — all appear to be equally precise — even though the various types of assets and liabilities may be subject to widely different degrees of precision.

The precision of measurements depends in large part on whether the measurement involves assumptions about future events. The measurement of some types of assets and liabilities does not involve those assumptions and therefore can be more precisely measured. Examples include:

- The reported amount of cash.
- The value of marketable securities traded on a major exchange reported in the financial statements at fair value.
- The amount of debt reported in the financial statements at amortized cost.

In many other cases, however, the measurement of assets and liabilities involves assumptions about future events. Examples include:

- Receivables subject to collection losses reported at cost less an allowance for estimated collection losses.
- Capitalized motion picture development costs reported at the lower of amortized cost or estimated realizable value.
- Inventory subject to technological obsolescence reported at cost less an allowance for obsolescence.
- An investment in a long-term contract reported under the percentage-of-completion method of accounting.
- Non-marketable investments reported at fair value.
- Contingent liabilities reported at the amount estimated to be paid.

Information about the relative precision of the measurement of assets and liabilities is critical for users. It provides users with insight into:

- The quality of reported earnings. Recently reported earnings are critical in assessing trends affecting the business and usually are important elements in users’ predictions of future earnings or
cash flows. Further, some users value companies by applying a multiple to reported earnings. Because of the importance of earnings to the users' judgments about value, it is critical that users understand the relative risk of overstatement or understatement due to uncertainties in the measurement of assets and liabilities. For example, company earnings that already are realized or do not depend on the occurrence of highly uncertain future events are deemed to be of higher quality.

- **Opportunities and risks related to existing assets and liabilities.** Information about uncertainties in the measurement of assets and liabilities is directly relevant to assessing opportunities and risks related to those specific assets and liabilities.

- **Opportunities and risks related to the business.** Information about measurement uncertainties also can be helpful in judging opportunities and risks affecting the business. For example, increasing uncertainty in measuring bad debts related to trade receivables may indicate problems with a company's customer base, which, in turn, may indicate increased risk of sustaining an upward trend in revenues, margin, and earnings.

Users agree that disclosures should be made about the estimates and assumptions used to measure assets or liabilities whose measurement is inherently imprecise (measurement uncertainties). They suggest that current disclosures about the imprecision of measurement are not adequate to meet users' needs for information.

The Committee recommends that disclosures about measurement uncertainties be improved. More specifically, companies should:

- Identify in financial statement notes the specific types of assets and liabilities subject to significant measurement uncertainties.
- For assets and liabilities subject to significant measurement uncertainties, disclose how the reported amounts were derived and explain the estimates, assumptions, and judgments about future events considered in their measurement.

The goal of the disclosure is to convey information about the relative imprecision of a measurement and the key assumptions about the future on which that measurement is based, as well as, if possible, the sensitivity of the measurement to changes in those key assumptions.

The key to meaningful disclosure is to be selective about the measurement uncertainties disclosed. Boilerplate statements that the measurement of various items in the financial statements is inherently imprecise are not helpful to professional investors, although it may serve as a useful caution to unsophisticated readers of the financial statements. However, focusing users' attention on the specific facts related to key measurement uncertainties is useful to all types of users.

Whether to discuss a particular measurement uncertainty should depend on:

- **The sensitivity of the measurement uncertainty to an assumption about the future and the materiality of the resulting change in measurement.** Disclosures about measurements that vary widely depending on modest changes in key assumptions about the future are more likely to be useful to users.
- **The likelihood that future events could be very different from the assumed future events implicit in the measurement of an asset or liability.** Disclosure becomes more useful as the uncertainty about key future events increases.
- **The imminence of possible changes in the measurement of an asset or liability because of changes in the assumptions about the future.** Disclosures about measurements that could change significantly in the near term are more likely to be useful to users.

Under those criteria, many measurement uncertainties are not sufficiently important to be discussed. For example, a company's trade receivables may be subject to credit risk. However, if the company's experience suggests that bad debts consistently have been immaterial and nothing suggests that it will be different in the future, there is no reason to discuss the measurement uncertainty associated with trade receivables.

Accounting standards already require disclosures that provide some insight into the precision of measurements. For example, FASB Statement No. 5, Accounting for Contingencies, focuses on the accounting and disclosure for loss
contingencies. The Committee's suggested disclosures for measurement uncertainties, however, differ from the disclosures required by Statement 5 in two important respects:

1. The concept of measurement uncertainties is broader than the scope of loss contingencies in Statement 5. For example, Statement 5 does not address measurement uncertainties related to long-term operating assets or investments in long-term profitable contracts.
2. Statement 5 requires disclosure of the nature of the contingency, and an estimate of the possible loss, or range of possible loss, or a statement that such an estimate cannot be made. In contrast, the Committee suggests that disclosures about measurement uncertainties also disclose how the reported amounts were derived and explain the estimates, assumptions, and judgments about future events considered in their measurement.

The AICPA Accounting Standards Executive Committee (AcSEC) has issued a proposed Statement of Position, Disclosure of Certain Significant Risks and Uncertainties and Financial Flexibility, which deals in part with measurement uncertainties. The Committee recommends that standard setters adopt a broad perspective on measurement uncertainties consistent with users' needs for information and the Committee's recommendations.

**Recommendation 6**

**Improve quarterly reporting by reporting on the fourth quarter separately and including business segment data.**

The importance to users of quarterly reporting, particularly quarterly reporting by public companies, is discussed in chapter 3.

Quarterly reporting by public companies has been accepted for years and many private companies report on an interim basis at the request of users. However, in many cases, interim reporting is not needed by users. For example, a trade creditor of a well-established, profitable company may be comfortable with annual reporting by its customer. The Committee is not suggesting that all private companies report quarterly. Because the need for interim reporting varies for private companies, they and the users of their business reporting should continue to negotiate and agree on the frequency of interim reporting, if any, as they do in current practice.

Because of its importance, the users of quarterly reporting are very interested in the quality and completeness of that reporting. They have offered several ideas for its improvement, two of which they feel particularly strongly about: fourth-quarter reporting and quarterly segment reporting.

**Fourth-Quarter Reporting**

Currently, public companies file quarterly reports with the SEC for the first three quarters as well as an annual report. They do not report separately on the fourth quarter. The users of quarterly reporting see little difference between the first three quarters and the fourth; they want to analyze a company quarter by quarter, including the fourth quarter.

Users acknowledge that fourth-quarter financial statements can be derived easily from annual and third-quarter statements. They argue, however, that they would benefit from management's analysis of fourth-quarter results, including an update about trends affecting the business, the effects of unusual and non-recurring transactions and events, and significant fourth-quarter adjustments. Current reporting does not provide users with that information.

Users recognize that companies cannot report on the fourth quarter until they are ready to report on the annual period.

The Committee believes reporting on the fourth quarter would be useful to users. Management's insight into trends and the effects of unusual and non-recurring items is as useful in the fourth quarter as it is for the first three quarters. Without fourth-quarter reporting, many users have no access to that insight.

Fourth-quarter reporting should be no different from reporting on other quarters except for disclosure of significant year-end adjustments. Notes related to year-end balance sheet amounts can generally be omitted if the fourth-quarter financial statements are included in annual reporting.
The Committee also believes public companies can report on the fourth quarter at acceptable cost. Most, if not all, of the information that would be reported for the fourth quarter, such as unusual and non-recurring items, management has had to identify and consider in developing the annual report. Further, the fourth-quarter report could be abbreviated by cross-referencing to material included in the annual report.

**Quarterly Segment Reporting**

Users also suggest that multisegment companies provide segment data in quarterly reports on the same bases as they provide them in annual reports. The call for interim segment information results from two analytical techniques that already have been discussed: analysis of a company segment by segment and quarter by quarter. The logical result of those techniques is analysis of a company's business segments quarter by quarter.

As discussed earlier, segment reporting provides users with insight about the different opportunities and risks of a company's diverse businesses. For many users, the business segment is the unit of analysis. Quarterly reporting by segment would combine the power of two useful analytical techniques and would allow users to better perceive changes in trends affecting each segment. For that reason, quarterly segment reporting is a high priority for users.

Some companies already report segment information quarterly because of user interest in the information. Companies that do not may refer to business segments in their quarterly MD&A, a point that frustrates users. Those facts underscore the usefulness of quarterly segment information.

The Committee believes companies can provide quarterly segment data at acceptable cost by following the Committee's earlier recommendation for segment reporting. Aligning external segment reporting with internal reporting, limiting segment data to key statistics that are available, and not requiring arbitrary allocations of costs for segment reporting would reduce the cost of reporting segment data on a quarterly as well as an annual basis.

**Recommendation 7**

Standard setters should search for and eliminate less relevant disclosures.

Over time, the cumulative effect of disclosure standards has resulted in a significant increase in the volume of information disclosed. For example, over the past twenty years, disclosures in financial statements have increased significantly in major areas such as leasing, business segments, related parties, pensions, postretirement benefits other than pensions, income taxes, fair value of financial instruments, and off-balance-sheet risk of financial instruments.

The expansion in business reporting has been well-received by users and has been generally sound, given the benefits of improved reporting and the increased complexity of the business environment and transactions. However, certain disclosures no longer may be as useful after a reporting standard has been in place for a period of time. For example, disclosures introduced to educate users about the mechanics of a new standard no longer may be as useful after users have become familiar with the new standard. Further, business conditions may have changed, thereby reducing the importance of a certain disclosure. Finally, despite research and due process by standard setters, a disclosure may not be as useful to users in practice as originally thought.

Standard setters and regulators periodically have reconsidered and deleted from their requirements less useful disclosures. For example, the FASB rescinded requirements for disclosures related to current cost/constant purchasing power information and earnings per share information related to non-public companies. Similarly, the SEC recently proposed eliminating some of the information now required in supplemental schedules.

Standard setters and regulators should expand their efforts to eliminate disclosures that are less useful. Eliminating less useful disclosures offers several advantages. First, it would reduce the costs of preparation and auditing without significant loss of benefit. Second, it would reduce the need for users to wade through excess material. Third, it would demonstrate to constituents the standard setters' concern for reducing costs associated with business reporting where possible and thereby reduce barriers to constructive changes. Finally, eliminating less useful disclosures would make room for more useful information, such as that consistent with the Committee's recommended model of business reporting.
In the Committee's discussion groups, other meetings with users, and survey, the Committee asked users to identify less useful disclosures that are now required. Unfortunately, users are reluctant to identify disclosures that should be eliminated. They reason that any disclosure could be helpful in at least some circumstances. Their reluctance also reflects a desire to know as much as possible about the company under analysis. Thus, the Committee's efforts identified few disclosures that are candidates for elimination.

Standard setters and regulators should not be discouraged because the Committee's work did not identify less useful disclosures. Although asking users to identify what to eliminate was not helpful, perhaps other approaches would be more effective. For example, standard setters could undertake or sponsor research that identifies current disclosures that are used rarely by users in their work. Users may well support such a review: a substantial majority of users indicated in the Committee's survey that they would be willing to give up less important disclosures to make room for more important information.

Other Recommendations

Based on its work with users, the Committee developed additional recommendations related to display, interim reporting, comparability and consistency, and key statistics and ratios.

Display of Information in Financial Statements

Distinguishing between the effects of core and non-core activities is one important way to improve the display of information in financial statements. There are others. In general, companies should increase the amount of detail in financial statements, particularly in the income statement, as a means of helping users better understand a business, the linkage between the financial statements and actual events, and opportunities and risks. More specifically, companies should consider the items listed in section I(A)4(b) of appendix II.

Interim Reporting

As discussed in chapter 3, users often analyze public companies quarter by quarter. Public companies currently report, in quarterly filings with the SEC, cash-flow information on a year-to-date basis and not for the quarter. Because users analyze companies quarter by quarter, interim reporting should include quarterly cash-flow statements.

Under current rules, interim financial statements can show less detail than financial statements filed for an annual period. In contrast, interim information should include uncondensed financial statements, consistent with users' need for more detail. However, condensed note disclosures remain appropriate at interim periods.

Certain amounts in interim financial statements are derived by estimation methods that may cause those amounts to be less reliable at interim dates than at year-end when reported amounts are based on more refined estimation methods. Examples include pension expense and cost-of-goods sold, both of which may ultimately depend on year-end valuations of the pension liability and inventory. Consistent with users' need to understand the relative reliability of information, companies should disclose the methods of computing reported amounts used in interim periods that differ from the methods used at year-end.

Comparability and Consistency of Information

In current practice, financial data for prior periods are restated in only very limited circumstances. Examples include changes in the definitions of business segments, corrections of errors, and changes in accounting principles when standard setters permit or require restatement. Consistent with users' needs for comparable and consistent information, companies should restate information in more circumstances than allowed in current practice. More specifically, financial data should be restated or reclassified for dispositions, accounting changes, changes in the definitions of business segments, and possibly other items as well if the restated information can be reasonably assembled and is necessary for a better and more complete understanding of the business.

As discussed in chapter 3, new accounting standards that do not preserve the consistency of information result in significant costs for users. Effective date and transition provisions that permit a new reporting standard to be adopted in any of several years and allow a choice of how to adopt, such as retroactive application, prospective application, and the like, are particularly troublesome for users. Standard setters should consider simplifying the procedure for
adopting new pronouncements by making them effective for all companies in a single year and prescribing only one method of adoption.

Key Statistics and Ratios

To help users with analyzing trends affecting a business, the Committee's model calls for a summary of key financial and non-financial data on a consolidated basis as well as for each industry segment. A company and the users of its business reporting should agree on the periods to be reported, which generally need not exceed five years.

Lower Priority Issues

Standard setters should defer considering issues that have lower priority according to the current evidence of users' needs.

One advantage of focusing on the information needs of users is that it helps identify high-priority areas for improving business reporting. A less apparent, but still important, benefit is that it provides insight about what areas are less important. This is particularly useful because it channels debate and resources away from highly contentious but less important areas and into more important issues, where improvements are likely to be of greater value. The Committee's study identified five such areas that standard setters should defer considering at this time; these are discussed below.

Value-Based Accounting Model

Some accountants criticize historical cost-based measurements used in today's financial statements. They argue that the historical cost of an asset or liability is either irrelevant or not as relevant as recent values and suggest that the mixed-attribute model currently used in practice should be replaced with a value-based model. The call for fair value accounting has been loud enough that it prompted the Public Oversight Board of the SEC Practice Section of the AICPA Division for CPA Firms to suggest that the question of the best accounting model be resolved:

The FASB should add to its agenda a project to study comprehensively the possibility of requiring the reporting of values and changes in values rather than historical transaction prices, either as a basis to propose changes to financial accounting standards or to explain publicly why such a change in accounting standards is impractical or otherwise inappropriate.

Users do not favor replacing the current accounting model, which is largely based on historical costs determined in market transactions, with a value-based accounting model. They would retain the current model because:

- It provides users with a stable and consistent benchmark that is highly useful for understanding the business, identifying trends, and valuing a business by projecting earnings and cash flows.
- It provides information that is reliable because the amounts are based on market transactions.

Conversely, users oppose a value-based accounting model because:

- The model is inconsistent with the manner in which most users value companies or assess credit risk. It is not the purpose of the balance sheet to provide an estimate of a company's value. Users generally do not value a company's continuing operations by adding the value of individual assets and subtracting the value of individual liabilities. Rather, they value continuing operations based on their future earnings or cash flow, which is usually the dominant driver of a company's value. Predicting earnings or cash flow usually is not dependent on or greatly assisted by knowing the value of individual assets or liabilities used in the business.
- It would introduce an unacceptable level of volatility or noise into the income statement and/or stockholders' equity which is not useful to users in assessing a company's future performance and prospects. A value-based accounting model often does not reflect the nature of an ongoing business.
- Because of the volatility of markets, value information would be stale by the time it is released.
- Value information lacks sufficient reliability to replace historical costs in financial statements. Estimates of value may be subjectively determined by management or based on thin markets or
models of hypothetical markets. Even for marketable assets, users often doubt whether a value at a point in time is representative of ongoing value.

- Users do not agree on the appropriate definition of value. Creditors, for example, are generally interested in liquidation values, perhaps in distressed situations. In contrast, investors are usually interested in longer term value.
- The benefits of reporting value information do not exceed the costs.

Fair or market value information is useful when combined with and compared to historical cost information. Fair or market values, if disclosed, should be in the notes to the financial statements or in accompanying schedules. Detailed assumptions underlying the estimates should also be a required part of the disclosure in order to permit the user to adjust the disclosed amounts. Users are willing to accept less reliability in the context of supplementary disclosures than in the context of measurement in the balance sheet or the income statement.

Users find value information useful for particular types of assets and liabilities and in certain types of industries. Some of the types of assets and liabilities mentioned include:

- Financial assets.
- Assets for which market prices from active secondary markets are available.
- Certain non-core assets, including non-operating assets and assets and liabilities intended to be sold, settled, or disposed of, as opposed to being part of the ongoing business.

Users view fair value as conceptually more applicable to financial industry activities than manufacturing activities, although they question fair value disclosures that fail to reflect matching of financial assets and liabilities.

Assets and liabilities should be recognized and measured at fair value only when users find it useful. Standard setters should continue to follow a mixed-attribute model, whereby assets and liabilities are measured in financial statements at cost, lower of cost or value, or fair value, depending on which information is most useful to users in the circumstances. Despite the periodic calls to do so, they should not pursue a value-based accounting model.

**Accounting for Intangible Assets, Including Goodwill**

Companies recognize purchased intangible assets in financial statements and generally measure those assets at amortized cost. In contrast, most internally generated intangible assets are not recognized. Intangible assets include, for example, brand names, technology related to products and processes that provide competitive advantage, patents, trademarks, franchises, and the like. They also include goodwill — the difference between the cost of an acquired company and the value of its identifiable assets less the value of its liabilities.

Some people suggest that internally generated intangible assets should be recognized in financial statements. They observe that, for many businesses, intangible assets are more important to a company's success than are its tangible assets. That importance is demonstrated, for example, by companies whose market values are several times greater than their book values, suggesting that the value of their unrecognized intangible assets may exceed the value of their tangible assets. Further, the importance of intangible assets appears to be increasing with the growing importance of service companies in the economy, which tend to be intangible-asset intensive. Even tangible-asset intensive businesses appear to be competing in the marketplace by relying more on technology, information, and speed than on heavy investment in tangible assets. Critics ask why the balance sheet should omit such critically important assets.

Despite the importance of internally generated intangibles, users generally oppose recognizing those assets in financial statements. In general, recognizing internally generated intangibles would not help users value companies or assess credit risk for the following reasons:

- Users generally do not value companies or assess credit risk by reference to a company's core assets or liabilities. Rather, they usually consider predictions of earnings or cash flows. Recognizing internally generated intangibles in the financial statements would not assist with those predictions.
- Users consider the valuation of intangible assets to be inherently unreliable.
• If recognized, many users would adjust reported amounts to remove the effects of recognizing internally generated intangibles, as many users do now for purchased goodwill. They would view the effects of recognizing intangibles as noise in the financial statements that unnecessarily clouds trends and hinders their ability to make predictions.

• Internally generated assets usually are used in the business and not sold. Thus, their contribution to future cash flows is often indirect and difficult to segregate and quantify. However, recognizing internally generated intangible assets would be useful if they are to be sold.

• Valuing intangible assets often would require estimating the future cash flows resulting from the competitive advantage that the intangible creates. Most users believe quantifying the effects of competitive advantage is the job of financial analysis, not of business reporting.

• Creditors have little reason to care about the identity and value of intangibles to assess the adequacy of their collateral because intangibles rarely are used as collateral for debt.

Some of these reasons are also applicable to purchased intangibles, suggesting that users may not find helpful the recognition of either purchased or internally generated intangible assets. Many users adjust reported amounts to exclude the effects of reporting purchased intangible assets, particularly goodwill. Other users do not. For them, recognizing purchased intangibles is consistent with today's transaction-based accounting model. Further, the initial value of purchased intangibles is more reliable than internally generated intangibles because it results from a third-party transaction. Although an argument could be made to prohibit recognition of all intangibles, users believe it is not worth changing current practice. Users that choose to adjust the financial statements for purchased intangibles can do so using the amounts currently disclosed in financial statements.

Although users oppose expanding the recognition of intangible assets, users are aware of the importance of those assets and the competitive advantage they may create for a company. Thus, they would welcome improvements in disclosures about the identity, source, and life of both purchased and internally generated intangible assets. Improved disclosures in this area would be consistent with much of the information in the Committee's model, which would provide insight into the identity, importance, and sustainability of a company's competitive advantages.

**Forecasted Financial Statements**

Users generally do not need forecasted financial statements from management for the reasons discussed in chapter 3. Thus, the Committee does not recommend that forecasted financial data be a required part of its business reporting model. However, the Committee's reporting model does include forward-looking information, which is useful to users in preparing their forecasts of financial performance.

Although users generally do not need forecasted financial statements from management, some, particularly prospective lenders to small, private companies, seek management's forecasts. The Committee believes the need for a management forecast generally is restricted to prospective lenders to small, private companies in certain circumstances. Most lenders that need forecasts will have sufficient bargaining power to compel management forecasts. Thus, standards should not require forecasted financial statements.

**Accounting for Business Combinations**

The FASB frequently receives requests to reconsider the accounting for business combinations. For example, the FASB's advisory council, FASAC, in its annual survey of potential agenda projects, consistently has ranked highly a project to reconsider accounting for business combinations.

The most common complaint relates to the distinction between the two methods of accounting for business combinations, the purchase method and the pooling-of-interests method (pooling method). Critics believe the criteria that distinguish purchases from poolings are arbitrary and not substantive. Thus, they assert, two business combinations that are substantially similar can be accounted for very differently depending on the form of the transaction. They suggest that the FASB do away with one method or the other.

Defenders of the purchase method argue that only that method reports the economic reality that most, if not all, business combinations are acquisitions of one company by another. They believe that the pooling method ignores the negotiations over values involved in a transaction and that the pooling method permits the acquiring company to report profits on the use or sale of the acquired assets that should be reported as the cost of acquiring the assets.
Defenders of the pooling method argue that some combinations are true mergers and not the purchase of one company by another and that those mergers should be accounted for as poolings by adding the companies as if they had always been together. Further, the pooling method preserves trends and thus facilitates interperiod comparisons — the assets, liabilities, revenues, expenses, and net income of the combined company are readily compared with those of the constituent companies before the combination — while the purchase method tends to disrupt trends and make the company after the business combination less readily comparable with the constituent companies before the combination.

While it is true that some users prefer the purchase method and some prefer the pooling method, most also agree that the existence of the two methods is not a significant impediment to users’ analysis of financial statements. A project to do away with either method would be very controversial, require a significant amount of FASB time and resources, and in the end is not likely to improve significantly the usefulness of financial statements.

Rather than a project to reconsider accounting for business combinations, users would prefer a project to strengthen disclosures about business combinations. For example, many believe there is not enough disclosure under purchase accounting about how assets are written up or down at acquisition and about the liabilities created at acquisition and how those liabilities are settled in later periods. They are concerned, for example, that some companies are overly conservative in measuring liabilities at the date of acquisition, resulting in inflated reported income in later periods.

Alternative Accounting Principles

In certain cases, such as accounting for inventories and property, plant, and equipment, companies have a choice of accounting principles. For example, in the case of inventories, companies can select first-in, first-out (FIFO); last-in, first-out (LIFO); average cost; or in some cases other methods. In the case of property, companies can depreciate the cost of those assets using the straight-line method or choose from a variety of accelerated methods.

The accounting method used can significantly affect reported income and financial position. For example, in times of higher inflation, companies may report significantly lower income and inventory under the LIFO inventory method than under the FIFO method. Reducing the number of choices would improve the comparability of financial information from one company to another — a key objective of financial analysis. That fact argues to narrow or eliminate the accounting principle options available to a company. Thus, for example, standard setters could pick one method of accounting for inventory and one method of depreciation for property.

A project to reduce or eliminate existing accounting options would be controversial. There are conceptual reasons that support each of the various methods currently used in practice, and different users have different preferences for the alternative methods. As a practical matter, users indicate that the current flexibility is not a significant impediment for users’ analyses, provided the methods used are disclosed.

ChangesRejectedBecause the Costs Exceed the Benefits

Because of costs, the Committee does not recommend that business reporting provide all the company-specific information that users need for which management is the best source. The practical constraints discussed in chapter 5 restrict the information to be provided in cases where costs could be significant. In addition to those constraints, the Committee rejected disclosure of certain specific financial information because it judged the costs to exceed the benefits. That information is discussed below.

Segment Information

Legal Entities

Because of the costs involved, the Committee chose not to recommend disclosure of information about the individual legal entities constituting a consolidated company. Creditors often lend money to such a legal entity and have an interest in understanding its opportunities and risks and how its operations and financial affairs relate to the other legal entities in the consolidated group. To meet their needs for information about legal entities, creditors sometimes request financial statements by legal entity, in a consolidating format.

The Committee rejected the idea of requiring segment reporting on a legal entity basis for three reasons. First, it is not practical to require companies consisting of many legal entities to report on each entity. To do so would result in
considerable costs for accumulating, preparing, and auditing the information. Second, the information may not be helpful because it frequently would require arbitrary allocations, allocations made solely for business reporting and not reported internally. Finally, while some users may find reporting on a legal entity basis useful, other users would not. They would prefer to focus on the consolidated company and its industry and geographic segments. Because legal entity reporting is needed by only a subset of users, it is too specialized to be required in general purpose business reporting and is best left to negotiation between a company and the users of its reports that have an interest in particular legal entities.

Financial Statements by Segment

The Committee also considered recommending complete financial statements for industry or geographic segments but rejected that idea because of the potential cost of providing that information. Ideally, users would like a complete set of financial statements for each industry and geographic segment. Since users view segments as the sources of a company's earnings and cash flows, they often apply valuation assessments to segments similar to the ones they apply to the company as a whole.

Despite the appeal to users of complete financial statements for each segment, the costs of providing the information likely would exceed the benefits and the usefulness is questionable. On the cost side, many companies do not prepare financial statements by segments for internal reporting purposes. Requiring companies to do so would mean they would have to create information for business reporting they do not use to manage the business. Preparing that information could be both difficult and costly. Further, public companies already are concerned about the potential competitive costs of disclosing segment data to competitors. Requiring complete financial statements would exacerbate those concerns.

In practice, complete segment financial statements may not be as useful as some believe. First, key financial statistics, such as sales or margin, could provide most of the insight provided by complete financial statements. If so, the incremental benefit may not be worth the added cost. Second, preparing segment financial statements often would require arbitrary allocations. The usefulness of statements based on those arbitrary allocations is questionable, particularly if management does not use the statements to manage the business. Rather than complete financial statements for each segment, the Committee suggests that companies report key financial statistics they already report internally.

Geographic Segments

Users generally want geographic segment information from companies that operate in geographically diverse regions. Although useful for many companies, geographic information may not provide much insight for some, as discussed in chapter 3. Because of that fact and the costs of reporting segment information, the Committee proposes flexible standards that would require geographic segment information only when it provides insight about the opportunities and risks a company faces, rather than require geographic segment information in all cases.

Display of Information in the Cash-Flow Statement

A majority of users prefer the direct method of reporting cash flows from operations to the indirect method. Some users would find it most useful if the cash flows from the operations portion of the cash-flow statement included the same captions as those on the income statement, that is, a cash-basis income statement.

Users prefer the direct method because:

- The direct method more closely tracks real-world events (such as the receipt of cash from customers, payment of cash to suppliers, employees, and others). Thus, it improves users' understanding of a business and provides insight that is not available from the indirect method.
- Users use the cash-flow statement in part to assess the quality of a company's reported income. That assessment is made easier by a line-by-line comparison of captions on the income statement to the cash-flow equivalent of those captions on the cash-flow statement.
- Users need to know the cash flows related to certain captions of the income statement to help predict core income and core cash flows. Those captions include the cash portions of restructuring charges, unusual and non-recurring items, discontinued operations, and extraordinary items.
The Committee does not recommend the direct method for three reasons. First, a substantial minority of users believes that the indirect method in current practice is acceptable or preferable. Second, the Committee's recommendations should provide most of the information that users who support the direct method seek. For example, many of the Committee's recommendations help users understand a company's business and the recommendations related to display help users predict core income and core cash flows. Third, the costs of reporting under the direct method could be significant because most companies do not currently capture the information required. Converting information systems to provide the information or determining the information from existing reporting systems could be costly.

Interim Reporting

Quarterly reports now provide information on a quarterly and year-to-date basis. Some users suggest that the information for the latest twelve months replace information on a year-to-date basis. They argue that the twelve-month information would allow them to better compare companies with different fiscal years. They also note that yearly periods are more consistent with the data they consider in their analysis.

The Committee does not recommend latest twelve-month data for two reasons. First, although some users argued for the idea, others preferred current reporting. For example, some users, particularly creditors, preferred year-to-date information over information for the latest twelve months. Second, users who want twelve-month information or information about quarterly cash flows could compute the information for themselves based on information already provided in business reporting.

Periods to Be Presented

To analyze the effects of trends, users want key data over a long time frame — often ten years. Although the Committee’s model includes a summary of key statistics, it is limited to five years of data. The Committee rejected reporting data for ten years for three reasons. First, the accelerating pace of change is making information about the more distant past increasingly obsolete. Second, the Committee believes that consistency of reported information is critical for users; thus the model encourages that companies restate information more frequently. Restatement is costly, particularly for ten years of data. Third, restatement of data from distant years would sometimes be impossible because necessary information is not available.

Footnotes

1. In the Public Interest — A special Report by the Public Oversight Board of the SEC Practice Section, AICPA, Public Oversight Board, March 1993, p.38.
To what extent should auditors be associated with the information provided by business reporting? That question is the second part of the Committee's charge.

The Auditor's Current Role in Business Reporting

Auditors are associated with business reporting in various ways. They usually are engaged to report on historical financial statements. However, auditors also issue special purpose reports related to specific amounts included in the accounting records, report on the system of internal accounting control, and report on prospective (forecasted or projected) financial statements.

Reports on Historical Financial Statements

Under current rules, the auditors' work on historical financial statements is performed under the following basic concepts:

- **Independence.** Auditors must be independent in fact and in appearance from the interests of the companies on which they report.
- **Two levels of assurance: audit and review.** Auditors can be engaged to either audit or review financial statements. In an audit — the higher level of assurance — the auditor reports whether the financial statements are fairly presented in conformity with standards. In a review, a form of negative assurance, the auditor reports whether he or she is aware of any material modifications that should be made to the financial statements. A review generally consists of inquiries of company personnel and analytical procedures applied to financial data. It involves less work than an audit, which includes confirmation, observation, recomputation, and other procedures in addition to analytical review. Even an audit, however, provides only reasonable, not absolute, assurance. It neither guarantees nor ensures the accuracy of the financial statements or the fairness of their presentation.
- **Report on the assertions of others.** The assertions in the financial statements are the responsibility of the company's management. The auditor's job, as currently defined, is to report on those assertions. With relatively rare exceptions, auditors do not assert. Rather, they offer opinions on the assertions of others.
- **Standardized reporting.** Auditors' reports on financial statements are highly standardized. Auditors have little flexibility to customize their reports. Thus, audit reports are generally the same from company to company.

The SEC requires that public companies obtain audits of their annual financial statements. The extent of auditor involvement with the financial statements of private companies is determined by negotiation between a company and the users of its financial statements and generally not by law or regulation. However, some private companies, such as financial institutions and insurance companies, for example, are required by law or regulation to obtain audits of their financial statements. Other private companies obtain audits of their financial statements due to a variety of factors, including size, nature of financing of the business, or the degree of risk perceived by users.

Auditors also issue audit reports on individual elements of financial statements, such as receivables and inventories. Users request those reports in areas of specific concern, such as collateral that secures a loan.

Reviews of financial statements are common. Smaller private companies arrange for reviews in place of audits of annual financial statements when the cost of an audit is a significant concern or when users perceive the risk to be low. Also, larger public companies often obtain reviews of the quarterly financial statements they file with the SEC. Auditors rarely provide assurance on quarterly or other interim financial statements of private companies.

Auditors seldom publicly report on sections of business reporting outside of financial statements, such as the description of the business and properties, the president's letter, MD&A, and the material in the proxy statement, although standards do not prohibit that reporting. Auditing standards require only that auditors read
the information in those other sections and bring to management's attention any matters that are inconsistent with the financial statements or the auditors' understanding of the facts.

**Special Purpose Reports**

In addition to the reports they issue on historical financial statements, auditors frequently are engaged to issue special purpose reports to specifically identified users of the financial statements. Special purpose reports, which result from negotiation between a company and users, are tailored to the unique requirements of the particular user. Examples include reports for underwriters regarding financial measurements disclosed in SEC filings in sections other than the financial statements and reports for creditors regarding compliance with contractual provisions in loan contracts. Unlike audit procedures in audits of financial statements, which are based on standards, the procedures supporting special purpose reports are specified by the user. Special purpose reports usually state only the procedures performed and the related findings; the auditor usually offers no opinion about what is being reported or about the sufficiency of the procedures for the user's purposes.

**Reporting on Internal Control**

A company's system of internal control serves various objectives. Three common ones are that assets are safeguarded, transactions are authorized, and accurate records are maintained.

Although reporting on the effectiveness of the system of internal control generally is optional, management of public companies occasionally report on the effectiveness of internal control systems. Those that do usually do so to add credibility to their business reporting, particularly the financial statements, and to acknowledge accountability publicly. However, auditors rarely report publicly on internal control, even when management does so. The auditor's report on internal control usually identifies management's assertion about the effectiveness of internal control over financial reporting and provides an opinion on whether that assertion is fairly stated based on control criteria.

One notable exception to voluntary reporting on internal control applies to certain financial institutions. The Federal Deposit Insurance Corporation Improvement Act of 1991 requires each large insured depository institution to include in its annual report to the FDIC — but not in its annual report to shareholders — a management report on the effectiveness of the institution's controls over financial reporting and an auditor's report attesting to management's assertions.

**Reports on Prospective Financial Statements**

Standards permit auditors to examine and report on prospective financial statements. Because public companies rarely include prospective statements in public reports and the SEC permits only the highest assurance level of reporting on such statements, auditor reporting on prospective financial statements of public companies is relatively rare. It is somewhat more frequent for private companies and usually results from negotiations between a company and users. An auditor's standard report on an examination of prospective financial statements includes an opinion about whether (1) the statements are presented in conformity with guidelines and (2) the underlying assumptions provide a reasonable basis for the prospective statements.

**Users' Needs for Auditor Involvement with Business Reporting**

The Committee included issues of auditor involvement with business reporting in its study of the information needs of users. More specifically, the study focused on questions in three categories:

1. **Importance of auditor involvement.** To what extent do users value auditor involvement with business reporting? What are the benefits to users of audits? What aspects of auditing are disappointing to users?
2. **Expanding auditor involvement with information not now audited.** To what extent would users benefit from expanding auditor involvement to include information in business reporting not now audited, such as MD&A? Are the benefits of audits greater for some types of information than for others?
3. **Expanding audit reports to include auditor analytical commentary.** Should audit reports be restricted to highly standardized reports or would users benefit from reports that include comments tailored to the specific company and circumstances? For example, should audit reports discuss the specific scope of
the auditors' work and the results of that work? In addition to offering an opinion on management's representations, should audit reports include the auditors' own commentary, based on their audit work? If so, what topics do users suggest that auditors address in their analysis? For example, should audit reports offer a qualitative evaluation of a company's reporting in addition to offering an opinion on the financial statements?

The results of the Committee's study follows.

**Importance of Auditor Involvement with Financial Statements**

Users believe auditor involvement provides independent assurance of the reliability of amounts reported and disclosed in financial statements not otherwise verifiable by third-party users. In the survey of users sponsored by the Committee, 95 percent of the participants agreed with that statement — 68 percent agreed strongly. Both measures were the highest degree of agreement for any of the 112 questions in the survey. The Committee's investor and creditor discussion groups also emphasized the importance to users of auditor involvement with financial statements.

Users believe auditors enhance the reliability of financial statement information for three reasons. First, audit procedures, such as observation, inspection, recomputation, and confirmation, verify the accuracy of reported amounts. Second, auditors focus attention on and encourage improvements in the system of internal accounting control. Those improvements, in turn, reduce the risk of errors in both interim and annual financial statements. Finally, auditor involvement provides a discipline for management to adhere to established reporting standards.

Users are concerned about current pressures on auditor independence. They believe the need to maintain a good business relationship with clients in a competitive audit environment could, over time, erode auditor independence. They also are concerned that auditors may accept audit engagements at marginal profits to obtain more profitable consulting engagements. Those arrangements could motivate auditors to reduce the amount of audit work and to be reluctant to irritate management to protect the consulting relationship.

Users also are concerned about the credibility of business reporting. Most believe that, in general, rather than report neutrally, business reporting tends to portray the company in the best possible light. Users are concerned about the credibility of reporting, as have earlier studies involving users, such as the 1987 study by SRI International, *Investor Information Needs and the Annual Report*, and the 1984 study by Hill and Knowlton, *The Annual Report: A Question of Credibility — A Survey of Individual and Professional Investors*.

Creditors using private company financial statements raise a different concern about auditor association with business reporting. Generally, users prefer audits over reviews because of the increased assurance that audits provide. However, they accept review reports when they judge the risks to be acceptable in a competitive environment. Creditors are concerned that companies may reduce the extent of auditor involvement to offset increased costs if accounting requirements are increased. Companies could, for example, reduce auditor involvement from audit assurance to review assurance or from review assurance to no assurance.

**Expanding Auditor Involvement with Information Not Now Audited**

Users are divided over the usefulness of expanding the scope of audits to include new types of information not now audited. For example, only 57 percent of those who participated in the Committee's survey agreed that auditors should provide some level of assurance about disclosures of forward-looking information. Further, only 52 percent agreed that auditors should provide some level of assurance on non-financial business information disclosed by management. Participants responded to the questions in the context of current business reporting. It is unclear how they would have responded in the context of the Committee's business reporting
Further, based on the Committee’s work with its discussion groups, users appear to not support auditor reporting on MD&A. They have two concerns:

1. They fear that auditor involvement may discourage management from reporting subjective information that may be hard to verify but that is nevertheless important to users.
2. They question whether auditors have the intimate understanding of the business and skills necessary to audit management’s discussion effectively. Users see MD&A as the place for management’s perspective on the business, and they do not want outsiders interfering with the communication of that view.

Although users are not enthusiastic about expanding the scope of audits, one exception relates to internal control. They believe business reporting would benefit from increased auditor involvement in internal accounting controls. The Committee’s discussion groups emphasized this point, as did the 1993 Association for Investment Management and Research Report, Financial Reporting in the 1990’s and Beyond. Page 58 of that report states:

“we advocate the continuous involvement of the auditor in the process that generates the financial information an enterprise disseminates externally. . .—we envision external auditors being substantially more involved than at present with the functioning of the internal systems that produce financial data for external consumption.”

Expanding Audit Reports to Include Analytical Commentary

A majority of users support expanding auditor reporting to include some form of analytical commentary. Discussion group participants noted that auditors know more about a company than auditors communicate in their reports, and they hoped to benefit from that knowledge, particularly in areas that would assist them in evaluating the quality of a company’s earnings. Users supported auditor commentary on the following:

- Audit scope and findings.
- The company’s accounting principles in relation to alternative principles, particularly principles used by other companies in the same industry.
- Reasonableness of significant assumptions and estimates used by management in the preparation of financial statements.
- Risks related to realizing recorded assets.

Users were not unanimous in their support of auditor analysis, and individuals placed greater emphasis on different areas of potential comment.

Recommendations to Improve Auditor Involvement with Business Reporting

The Committee developed recommendations to improve business reporting through enhancing auditor association with that reporting. In developing those recommendations, the Committee considered users’ needs for auditor association, alternative ways to meet those needs, and the costs and benefits of the alternatives. The Committee developed recommendations in four categories. Two address auditor involvement with the elements of the Committee’s business reporting model. The third relates to analytical commentary in auditors’ reports and the fourth deals with other matters.

Recommendation 1

Allow for flexible auditor association with business reporting, whereby the elements of information on which auditors report and the level of auditor involvement with those elements are decided by agreement between a company and the users of its business reporting.

As discussed under the Committee’s comprehensive business reporting model, the Committee encourages flexible reporting based on the information needs of users. Under that concept, only certain elements of the
model are reported, depending on users' needs for information as resolved through negotiations between users and companies.

The Committee concluded that the same flexibility concept also should apply to auditor association with the elements of the model that are presented. Under that concept, users and companies would negotiate to identify the elements of the model on which auditors would report and select the level of assurance the auditor would provide on each of those elements as well. For example, they could consider various mixes of assurance levels for different elements within the same business report. However, the level of assurance on the financial statements would set the maximum level of assurance possible on all other elements reported. Thus, if auditors did not report on financial statements, they could not report on any of the other elements of information presented in business reporting. Further, greater assurance cannot be provided in another element of business reporting than is provided on the financial statement element.

The Committee is not recommending required expansion of auditor involvement with business reporting. Rather, it recommends the flexible reporting concept for four reasons.

1. Users' needs for audited information differ. For example, users differ on the level of auditor assurance they perceive they need. Some need an audit, whereas others, under certain circumstances, would accept a lower level of assurance, such as a review, or no assurance at all. The needs for audited information differ depending on the particular circumstances such as the size of the company, its perceived riskiness, and experience and comfort with management. Users also differ over the usefulness of auditor association with information outside of financial statements. The Committee therefore believes that customized reporting is necessary to meet the diverse information needs of users.

2. The costs of providing audited information differ. Differences in costs largely explain why the marketplace accepts review reports or no level of assurance on financial statements rather than always requiring audit reports. Differences in costs of auditor association obviously affect the cost-benefit trade-off considered by users and companies. The Committee concluded that the cost-benefit trade-off is best decided by the parties affected by that trade-off rather than by standard setters.

3. The Committee's information about users' needs for audited information and the costs of providing that information are based on the current state of business reporting. Adoption of the Committee's reporting framework could significantly affect both the perceived need for auditor involvement and the costs of that involvement. It is impossible to predict how the cost and benefit trade-off will be affected in the future.

4. The Committee concluded that the level of auditor assurance selected for the financial statement element, if any, should determine the maximum level of assurance that could be provided on other elements reported. The auditors' work on financial statements and the related system of internal control provides the foundation on which other work is based. The Committee concluded that the level of assurance on elements outside of financial statements could be no stronger than that foundation. Thus, for example, without that foundation, the auditor could provide no assurance on information in other elements.

Recommendation 2

The auditing profession should prepare to be involved with all the information in the comprehensive model, so companies and users can call on it to provide assurance on any of the model's elements.

Current standards are not adequate to deal with the varying nature of information in the comprehensive model of business reporting. Current standards focus on audits or reviews of financial statements and the information in accounting records. However, the model includes information not derived from accounting records, such as business strategy. It also includes information that is more subjective than the types of information on which auditors now report, such as business opportunities and risks. Reporting on the various elements of the model, if requested, would require new standards and, in some cases, new skills for auditors.

The Committee believes that one standard setter, the AICPA Auditing Standards Board, should assume responsibility for new audit standards. The board traditionally has established standards for audits and focusing responsibility on a single standard setter offers the best opportunity for progress.
Reporting on Objective Information in the Comprehensive Model

Much of the information in the comprehensive model is objectively verifiable, even though auditors currently do not report on that information. Further, some of the information is derived from the accounting records used to produce financial statements. Examples include the number of employees and the units of product sold.

To the extent possible, current standards should be retained. The Committee believes they can be used to guide auditors in auditing information that can be verified objectively. Further, auditors can report on that information following the reporting language used in audits of financial statements.

The Committee believes the existing standards are adequate for auditing and reporting on information in some elements of the model but not in others. The elements for which existing standards are adequate are:

- Financial statements and related disclosures.
- High-level operating data and performance measurements that management uses to manage the business.
- Directors, management, compensation, major shareholders, and transactions and relationships among related parties.
- Scope and description of business and properties.

Reporting on Subjective Information in the Comprehensive Model

Some of the information in the elements of the comprehensive model is composed almost entirely of management's beliefs, intentions, and predictions; in many cases, there may be little objective evidence available (at least within practical bounds of time and costs) to support the veracity of those assertions. Further, auditors could have difficulty determining whether the disclosures are complete. The elements of the model that contain this type of information are:

- Reasons for changes in the financial, operating, and performance-related data and the identity and past effect of key trends.
- Opportunities and risks, including those resulting from key trends.
- Management's plans, including critical success factors.
- Comparison of actual business performance to previously disclosed opportunities, risks, and management's plans.
- Broad objectives and strategies.
- Impact of industry structure on the company.

For those types of information, existing audit guidance is not sufficient and new standards will be required. The Committee recommends a different level of assurance from the level provided for information that is verifiable objectively. For cost-benefit reasons, that assurance should be at a lower level.

More specifically, that assurance should be expressed using a "reasonable basis for presentation" and "conformity with presentation standards" approach in the style of current attestation standards. Under that approach, the auditor would report that the element is presented in conformity with the respective standards of presentation and that management has a reasonable basis for the underlying assumptions and analyses reflected in that element. In contrast, the audit of more objective information states that the element is fairly presented, in all material respects, in conformity with the applicable standards. This is not to argue that the Committee concluded the elements identified for reasonableness assurance are incapable of a fairness opinion; rather, it concluded the need to reach for fairness may be unnecessary. Given adequate implementation time, the Committee believes that users will be able to understand the differences in how elements are audited for fairness versus reasonableness based on differences in the inherent nature of the information being audited.

Appendix III includes an illustration of an auditors' report on the comprehensive model. That report illustrates the higher level of assurance for some elements and a lower level of assurance for others.

Some people have questioned whether auditors have the skills and expertise to be associated with information
outside of financial statements. Some of the information on which auditors may be asked to provide assurance may be beyond the ability of current auditors to evaluate. Examples include disclosures regarding the likelihood of engineering achievements and predicting certain technological directions or evolution. In such cases, auditors may find it necessary to obtain skills beyond those traditionally required.

An analogy may be drawn to the U.S. General Accounting Office, an agency that employs many engineers, scientists, and others with skills in addition to or other than accounting and financial auditing. In conducting audits of federal programs, these skills and many others are necessary to design and perform effective, broad-scope audits. Auditing firms, in some cases, have developed groups of individuals with skills other than accounting and auditing. Examples include actuaries and operations research analysts whose skills already are being applied in unique audit situations.

The Committee acknowledges that new skills will be needed to audit the broader disclosures of the comprehensive model. Those added skills will require new ways of building auditing teams, planning and supervising their efforts, and reporting the results of their work. The need for better, broader skills should not be a limiting factor to providing more useful business reports that are capable of receiving audit assurance. The reverse is, in fact, more important: Auditor skills should be challenged, grown, and redirected constantly so auditors are capable of dealing with new types and forms of information.

**Standardized Opinions**

The auditor's opinions on the various elements of information in the business reporting model should be standardized, just as auditors' opinions on financial statements are standardized today. Standardized opinions are useful to users because they clearly state the auditor's conclusion. Users want and expect a conclusion by the auditor. Further, with standardized opinions, users easily can spot deviations from the standard — deviations that otherwise might be missed with non-standardized reporting.

The Committee considered earlier experience with non-standardized reporting, sometimes called "long-form" audit reports. Those reports included greater detail about procedures and accounting principles employed. The Committee concluded that the historical long-form report was not an acceptable alternative to a standardized opinion. Long-form reporting created several problems, the largest being ambiguity: readers were confused about the auditor's overall conclusion.

The usefulness of standardized reporting does not apply to auditor commentary. The objective of auditor commentary is not an opinion on the fairness or reasonableness of information in a reporting element. Rather, the usefulness of auditor commentary depends upon the auditor's unique insights in particular circumstances. Reporting that insight would require flexible not standardized reporting.

**Alternative Assurance Levels**

The Committee focused on the nature of reporting the maximum assurance on various elements of the comprehensive business reporting model. With the flexibility inherent in the comprehensive business reporting model, there is an opportunity to consider various mixes of assurance levels for different elements within the same business report. Further, given the varying nature of information contained in the elements, other levels or forms of assurance could be provided besides the audit and review levels currently available. The Committee did not develop conclusions about new levels of assurance because of time and resource constraints and in light of the recently established AICPA Special Committee on Assurance Services. However, the Committee suggests that the Committee on Assurance Services and the Auditing Standards Board pursue the subject using the Committee's business reporting model.

**Recommendation 3**

*The newly formed AICPA Special Committee on Assurance Services should research and formulate conclusions on analytical commentary in auditors' reports within the context of the Committee's model, focusing on users' needs for information.*

The model for audit reporting historically has divided responsibilities between preparers and auditors. The preparers make representations in financial statements; auditors give an opinion about whether the financial
statements comply with generally accepted accounting principles. The preparers assert; the auditors attest. The reasons for this division reflect decades of development of ideas about auditor independence, materiality, legal liability, and other concepts that have been codified into rules on how auditors express an opinion on financial statements. The result is rules that create highly standardized reports. Departures from the standard language are easy to detect and meaningful. As a result, departures from the standard language frequently are viewed as "warnings" or "bad marks." Sometimes that is exactly what they are intended to be. The financial reporting community seeks "clean" opinions (reports that use only the standard language).

Some have asked whether auditors' reports must always be framed in such standardized terms. Undoubtedly, the auditor must conclude on the fairness of the financial presentation, but could or should the auditor also provide a subjective view of the matters audited? Could there be an "auditor commentary" as well as a standardized audit report? The idea is not new; however, the Committee debated the question within a new context — the Committee's recommendation for a comprehensive business reporting model.

The following discusses the results of the Committee's research about users' needs for auditor commentary. It highlights the benefits of auditor commentary and the barriers and the implementation concerns for that type of reporting.

The AICPA Board of Directors formed the Special Committee on Assurance Services to consider the broad area of auditor assurance and make recommendations for changes to meet users' needs. The Committee supported the board's decision. The new committee will delve into auditor activities and related users' needs beyond the Committee's work. The following discussion sets forth findings so the new committee can enhance its consideration of auditor commentary based on what the Committee has learned.

Observations About Users' Needs

Users with whom the Committee met were divided in their support of auditor commentary, and individual users placed greater emphasis on different areas of potential comment. Furthermore, it is not clear whether users were interested solely because they sought the auditors' viewpoints or because current business reporting, including MD&A, was not providing needed information the auditors' comments might disclose. The comprehensive model was designed to provide more useful information, both qualitative and quantitative. The Committee did not research user attitudes and needs for auditor commentary within the context of the recommendations for the comprehensive model. Consequently, more research is required to determine the user need for auditor commentary in light of comprehensive model disclosures.

Benefits of Auditor Commentary

**Independent Perspective.** The independent view of the auditor constitutes useful information in addition to the reasonable views of management. Management's goals and motivations differ from those of the auditor. That is appropriate. Management occupies a position of stewardship and (naturally) believes in the programs and activities it has or will initiate. The auditor occupies a different position and has a different perspective. The auditor is more objective, dispassionate, and skeptical, for example, about the position and prospects of the company.

Even if management conforms its views to those of the auditor and makes representations consistent with the auditor's views, it is important to establish and report the auditor's independent observations that best characterize the situation and not merely express auditor assurance that management has a reasonable basis for its reported views. This distinction underlies the case for requiring that the auditor formulate and communicate an independent view about the defined circumstances on which professional standards would require comment.

**Valuable Information for Users.** Whatever opinions the auditor develops as a result of procedures performed could provide more to users than they are receiving currently. Moreover, the perceived independence of auditors is enhanced when auditors render clean opinions but also offer observations that help users understand the subjective matters auditors had to evaluate in reaching those clean opinions. Auditor commentary may alleviate the perception of certainty surrounding financial statements by highlighting the judgments inherent in business reporting.
Barriers and Implementation Concerns of Providing Auditor Commentary

**Impact on Independence and Legal Liability.** Auditors have a unique role in business reporting. It is widely accepted that analysts may differ in their interpretations and analyses of business reports. Inevitably, analysts will be wrong, at least some of the time. Auditors, on the other hand, are not expected to be wrong. Having auditors expand reporting to include commentary could raise user concerns that auditor decisions about fairness would be influenced by previous comments. Independence is key to the value of auditing. Auditor commentary could erode independence.

Legal liability related to auditor commentary must be tolerable. Auditor commentary related to financial statements would blur the distinction between preparer-asserter and auditor-attester and thereby may impose more reporting responsibility and legal liability on the auditor. Further, auditor commentary on areas outside of financial statements may expose the auditor to new and untested areas of legal liability.

**Impact on the Content of Management's Report.** It may be unlikely that auditors could provide meaningful commentary that would not otherwise appear in management's report. Currently, auditors consult with management about the content and readability of disclosure both in and outside financial statements. It may be difficult for an auditor not to propose useful observations to management and, instead, include them in an auditors' report. Accordingly, auditors may not be able to add information to a business report. Instead, the result may be additional standardized language or repetition of management's analytical comments.

Auditor commentary would require a substantial, and perhaps cultural, change by management in the relationship and expectations of the role of the auditor. For example, the presence of auditor commentary in today's environment may be considered by management to be threatening, undermining the credibility of management's report. And when there were honest differences in analytical views between management and auditors, users would have to be able to understand how reasonable people can have different interpretations of the same facts.

If there is an information need that auditor commentary could fulfill, the question that could be raised is why accounting standards, including the Committee's comprehensive model, do not impose that reporting obligation on management in the first place. Management may be in the best position to make disclosures. If auditor commentary is needed to fill gaps left by management's report, then accounting standards could be revised to clarify management's obligation.

**New Standards and New Skills Needed.** Standards would have to be developed to govern this reporting. Auditor commentary should not be essentially free-form. There would need to be a standard set of judgmental areas, such as choice of accounting principles, significant estimates, and matters affecting the quality of reported earnings, to be addressed in each report. These would be guidelines at a high level.

Standards setters would need to consider whether auditor commentary is required or optional. Some believe this reporting would not be viable unless it was required. That is, by making the report required, the profession would invest the training and quality control effort to make the reporting useful. Others believe imposition of these reporting requirements would be contradictory to the notion of a negotiated scope of assurance recommended by the Committee.

The costs of auditor commentary are unknown. Some speculate that the marginal costs are small because the information already has been obtained as part of the existing audit process. The auditor already responds to similar requests from audit committees indicating that such commentary can be provided at acceptable cost. Others argue that audit work is not currently designed to support reports of this nature to outside third parties. For example, under current audit standards, auditors may challenge estimates in financial statements using methods that are different from those used by the preparer. By these means, the auditor can judge whether the preparer's estimate is reasonable but may not be able to explain how variations in the preparer's approach could have changed the estimate materially. Until standards for auditor commentary are proposed and field tested, the question of cost is unanswerable.

Auditor commentary may require new skills within the audit team, depending on the nature of the comments required by standards. The auditor may need different training, and new types of audit team members may be needed. This, in turn, would have implications on auditors' quality control procedures and standards.
Conclusion

The Committee expects the AICPA Special Committee on Assurance Services to continue the process of research and exploration of auditor commentary. Much more must be understood about users’ possible need for the information, the nature of this type of reporting, and whether the significant barriers and implementation concerns can be resolved. The Committee urges the Special Committee on Assurance Services to research and formulate its conclusions within the context of this Committee’s comprehensive model, with a focus on the information needs of users.

Recommendation 4

The profession should continue its projects on other matters related to auditor association with business reporting.

During its study of the information needs of users, the Committee gathered useful information about reporting on internal control, concerns about the credibility of business reporting and pressures on auditor independence, and responsibility for detecting fraud. The AICPA and others currently have major projects under way specifically addressing each of those areas. To avoid duplication of effort and to focus its efforts on areas not otherwise being addressed, the Committee excluded those areas from the scope of its work. However, the Committee supports work in those areas and has forwarded what it learned from users to the respective organizations. The Committee recommends that they consider what the Committee learned in forming their recommendations.
Chapter 8 — Facilitating Change in Business Reporting

Worthy ideas to improve business reporting must be translated into action or they create no public benefit. Such action depends on many factors — the whole set of attitudes, rules, customs, institutions, and practices that affect the information companies provide to users. The factors can be more or less hospitable to improvements. This chapter presents the Committee's recommendations for improving the factors pertaining to the institutional processes that can create improvements.

Recommendation 1

National and international standard setters and regulators should increase their focus on the information needs of users, and users should be encouraged to work with standard setters to increase the level of their involvement in the standard-setting process.

There should be little debate in the United States over the foundation role of the information needs of users in business reporting. The FASB early in its history put users’ information needs at the center of its conceptual framework, and the rhetoric of standard setting for years has featured the information needs of users. The purpose of business reporting is to provide useful information to users. And because the process is designed to serve their needs, users can be particularly helpful to standard setters in:

- Making agenda decisions, by indicating the relative usefulness to users of alternative projects.
- Understanding the relative benefits of proposals.
- Weighing benefits and costs, because users who are owners incur the costs of business reporting as well as share in its benefits.

Unfortunately, there has long been a contrast between the known importance of users’ needs and the relative absence in the standard-setting process of either reliable data about those needs or sufficient input from users. This is true of all standard-setting bodies, from the FASB to AcSEC and the IASC.

The FASB typically receives hundreds of letters commenting on its proposed position on a major issue, but most come from preparers and auditors, with only a handful from users. Few users testify at public hearings or participate in field tests. Over the years neither the FASB nor FASAC, the FASB's advisory council, has had a notable proportion of members with backgrounds as full-time users. AcSEC, the AICPA’s fifteen-member senior technical body on accounting, has no users, and very few users serve on its related committees. The IASC, the board responsible for international standards, also claims few users, either on the board or its advisory group, and it receives relatively few letters from users commenting on its proposals.

User participation in the standard-setting process should be brought up to the level of the standard setters' other constituents. However, getting more user involvement in the standard-setting process will be difficult. Standard setters have encouraged user participation in the past with only limited success. Users may not be motivated to participate because they see little personal benefit from doing so or they may be uncomfortable in analyzing accounting issues with people who do so for a living. Despite the obstacles, however, user participation can and should increase. Business reporting and all those affected by it are not well served by the current limited level of user participation.

Those responsible for standard-setting processes, such as the Financial Accounting Foundation, the FASB's parent organization, and standard setters themselves should more effectively recruit users for service on standard-setting boards, advisory councils, and task forces. They should encourage users to write more comment letters and to participate in public hearings and field tests. But encouragement alone may not be enough. Those responsible for standard-setting processes should seek formal commitments to increase user participation from institutions representing users, such as the Association of Investment Management and Research and the Robert Morris Associates, or major institutional investors and other organizations. They should also consider novel means to get qualified users to focus exclusively on users' needs for the benefit of the standard-setting process (for example, focus groups and task forces made up of recently retired users).

High-quality research on users’ needs for information has been limited. Much of what is written about users’
needs for information is speculative that is, the author speculates about what would or would not be useful to users, not testing the speculative ideas with empirical data or with direct observations or otherwise working with users. Most of the empirical research on users' needs that has been done is not intended to support standard-setting activity and, as a result, is too broad or narrow to be helpful to standard setters. The Committee decided to conduct and sponsor new research because of the scarcity of relevant research.

Standard setters have sponsored and undertaken some research that has helped develop standards consistent with users' needs for information and have used other research produced by academics. The FASB, for example, considered findings from capital markets research in making decisions on Statement 33 (Financial Reporting and Changing Prices) disclosures, marketable securities, and postretirement benefits other than pensions. However, standard setters should more aggressively search for, sponsor, and undertake research about how users make decisions and about the relative usefulness of various types of information in their decision-making processes. What has been done in the past is not enough. There is no substitute for reliable data on which to base decisions. The research should involve a wide range of projects that search for users' needs for information from a variety of perspectives. Examples of the types of research that would be helpful are listed in chapter 5.

To help motivate competent researchers to undertake the right kinds of research, standard setters should become more active in helping steer research programs into areas that are relevant to the standard-setting process. For example, standard setters could become more involved in advisory boards at universities and with research foundations. They could also increase the frequency with which they jointly sponsor research with other organizations, such as the Financial Executives Research Foundation, the Institute of Management Accountants' Foundation for Applied Research, and the AIMR.

Recommendation 2

U.S. standard setters and regulators should continue to work with their non-U.S. counterparts and international standard setters to develop international accounting standards, provided the resulting standards meet users' needs for information.

This recommendation recognizes both that developing international accounting standards is a worthy goal and that their development should be consistent with the current U.S. commitment to base accounting standards on users' information needs. The alternative is to give the development of international standards priority over the fundamental purposes of business reporting, a course that could result in lowest-common-denominator standards. Such a priority is evident whenever international standards result in a net loss of useful information, whether through less stringent requirements or through the variety or effects of accounting alternatives. The Committee rejects any approach that would sacrifice users' needs for information to the goal of creating international standards.

The focus on users' needs recommended in the passage above offers a common framework for standard setters in all countries. Under this approach, users' information needs, proactively determined by research and the participation of users, would be the basis for international accounting standards. This approach, which is different from attempting to reconcile differences among the standards of different countries, should enable international standard setters to arrive at standards that serve the information needs of users. It should also allow standard setters to identify instances, if there are any, where international standards are not possible because information needs among different groups of users are incompatible.

Differences in economies, regulations, culture, and standard-setting objectives have led to the diverse reporting practices now in place in the international community. The diversity is extensive. Some countries do not recognize assets and liabilities that others do. Measurements of financial statement items differ. There are also differences in display practices and varying levels and types of disclosure.

Differences among nations' business reporting practices are the basis for the strong arguments in favor of international standards. The differences make intercompany comparisons more difficult and add risk to decisions on allocating capital among companies located in different countries. Uniform standards would facilitate securities registrations by foreign companies. It is typically more costly for a U.S. company to prepare disclosures under the more comprehensive U.S. requirements than for a foreign company to comply with the disclosure requirements in its Home country. U.S. companies suffer competitive disadvantage when entities in countries with relatively limited disclosure requirements have access to the fuller disclosure required in the
United States. Multinational companies are faced with the cost of complying with different national standards, and the difficulties can inhibit their access to foreign capital markets.

These arguments are a powerful incentive to work for high-quality, effective international standards. But the arguments do not justify sacrificing users’ needs for information to the goal of international standards. Past international standards have permitted wide flexibility or have reduced information requirements in order to obtain agreement among countries participating in the standard-setting process. However, international standard setters are working to reduce that flexibility and improve disclosures. Focusing on users’ needs for information would facilitate that important process.

Business report users in the United States have expressed concern that international standards often result in reporting that is less useful to them. Although most favor a single set of accounting standards, if forced to choose, users prefer diversity when international standards result in a net loss of useful information. They generally believe their needs are best met by U.S. reporting standards.

An alternative to international standards is the policy of mutual recognition, under which two or more countries agree to accept, for purposes of registering foreign company securities in their capital markets, compliance with country-of-origin disclosure standards. Both mutual recognition and uniform international standards facilitate securities registrations by foreign companies, but the approaches are otherwise very different. Mutual recognition accepts differences among disclosure presentations. Such differences hinder intercompany comparisons by users and create competitive disadvantages for disclosing companies, disadvantages that international standards are, ideally, supposed to eliminate. In these ways, mutual recognition can sacrifice users’ needs. Finally, mutual recognition can inhibit future efforts to develop international standards, because those who support that development primarily for purposes of encouraging foreign registrations will have lost their motive for continued support.

Users are particularly concerned about the loss of information that may result under mutual recognition. The Committee recognizes that mutual recognition would do no disservice to users’ needs whenever the differences among disclosure presentations are immaterial. Apart from those circumstances, however, the Committee opposes mutual recognition.

**Recommendation 3**

Lawmakers, regulators, and standard setters should develop more effective deterrents to unwarranted litigation that discourages companies from disclosing forward-looking information.

The Committee’s research shows that the current litigation environment has had a dampening effect on the disclosure of forward-looking information. Moreover, because of that environment, the Committee was constrained to qualify its recommendation on enhanced disclosures of forward-looking information, holding it in abeyance until the threat of unwarranted litigation is reduced. The follow-on recommendation here is that steps should be taken to reduce unwarranted litigation that makes disclosures of forward-looking information inordinately risky. The reduction must be sufficient to ameliorate the unreasonable threat of litigation costs incurred for competently prepared, good-faith disclosure of forward-looking information that serves the interests of users.

Meritless litigation is certainly unwarranted. In the typical meritless suit, a drop in a company's stock price triggers a suit alleging fraudulently misleading disclosure, or lack of disclosure, and a favorite allegation is that predictive information was misleading, not having been borne out by events. The cost of defending those suits is very high — so high that exoneration can be more expensive than settling. In addition, the risk of losing the suits is always a possibility accompanying the defense costs, despite the suits’ lack of merit. As a result, settlements can be sensible business decisions, and they are typical. The transfer of wealth from the settlements makes additional meritless suits more likely.

All of this is well known. It has been discussed in congressional hearings, and the dampening effect of meritless suits on voluntary disclosure is common knowledge. Companies, well aware of the risks of meritless suits, have been reluctant to make forward-looking disclosures. This reaction is an understandable defensive measure to reduce litigation risk, but its consequence is to deprive users of information and inhibit the progress in business reporting that comes from experience with voluntary disclosure. Users are concerned with the
effect that meritless litigation is having on business reporting.

There are three sources of potential relief from the problem of meritless suits over forward-looking disclosures — lawmakers, regulators, and standard setters. Legislators and regulators can create more effective safe harbors and can adopt other measures that discourage unwarranted litigation. The anti-meritless-suit provisions in the legislation introduced in 1994 by Senators Christopher J. Dodd and Pete V. Domenici are examples of the latter.¹

Standard setters can reduce the threat of unwarranted litigation by developing provisions for forward-looking disclosures that enable companies to demonstrate compliance. The incidence of meritless suits over forward-looking disclosures should be dampened if companies can demonstrate that although results differed from forward-looking disclosures, the disclosures had been competently prepared in good faith in compliance with authoritatively established standards. Taking as an example the forward-looking disclosures in the Committee’s reporting model (see chapter 5), the standards could be more or less open-ended. If the issue was risks, specific risk types characteristic of particular industries could be identified for companies in each industry to disclose. Compliance would then be far more easily demonstrated than by following a blanket obligation applicable to all companies to disclose all material risks. The former approach to disclosure is far less open to accusations of inadequacy in light of subsequent events.

It is often argued that litigation over disclosure serves a valuable social function: It provides recompense to the defrauded, and the desire to avoid litigation promotes care by companies in the discharge of their accountability obligations and vigilance by auditors in examining financial statements. These arguments apply only to legitimate claims of fraudulent disclosure. They do not apply to meritless suits. In a meritless suit there are no defrauded victims, and there is no inadequate care by companies or by auditors. The only suits targeted by this recommendation are meritless suits. Measures can diminish them without weakening mechanisms to redress legitimate claims.

Recommendation 4

Companies should be encouraged to experiment voluntarily with ways to improve the usefulness of reporting consistent with the Committee’s model. Standard setters and regulators should consider allowing companies that experiment to substitute information specified by the model for information currently required.

Standard setters, regulators, and users should encourage companies to experiment voluntarily with improved reporting based on the Committee’s model. The experimental presentations can be supplementary to what is now required, but with the cooperation of standard setters and regulators, they can also take the form of replacing currently required presentations or parts of them. In that case, standard setters and regulators would have to grant participating companies permission to substitute items from the model for required items. For example, under current rules, companies cannot separately display the effects of core and non-core activities and events. Permission would have to be granted in order for the model’s core-non-core approach to replace what is currently required.

Some voluntary efforts to improve reporting have met with success. For example, companies participating in FASB field tests over the years have provided valuable information for standard setting. Voluntary reporting has been stimulated by cooperation between companies and analysts. The interaction of the AIMR Corporate Information Committee and companies evaluated in its annual rankings of corporate reporting has encouraged many initiatives, including presentations of quarterly segment data and non-financial operating data. Corporate factbooks are another example of voluntary corporate disclosure that has matured from the interaction between disclosing companies and investment analysts.

Experimentation could provide information about costs and benefits, generate insights to refine ideas, and in other ways give standard setters and regulators a better baseline from which to consider the Committee’s recommendations. Successful experiments that demonstrate that practical, cost-effective improvements are possible would both accelerate improvements and help avoid pitfalls.

Recommendation 5

Standard setters should adopt a longer term focus by developing a vision of the future business
environment and users’ needs for information in that environment. Standards should be consistent directionally with that long-term vision.

The relevance of the information businesses report to users is affected by a constantly changing environment. Economic and technological change occurs swiftly, and the changes affect the needs of users of business information. Standard setters should have some systematic approach to awareness of the likely importance of these changes for business reporting so that agenda priorities are well chosen, resources effectively deployed, and standards appropriate to the environment in which they are to be applied.

No one can have detailed, accurate knowledge of the future, but developing such knowledge is not the aim of this recommendation. The aim is to identify enough of the broad outline of the future to improve planning and facilitate a strategic approach to standard-setting tasks. Responding to problems as they arise ensures that reporting standards will always lag behind users’ needs for information. Even if the problem-solving approach was once suitable, it will not suffice in the rapidly evolving era we have entered.

The kind of vision called for by this recommendation embraces broad questions. What, for example, will be the relationships among the parties to the business reporting process in the future? Who will those parties be? Will customers, suppliers, and employees, for instance, take their places beside investors and creditors as focal-point users of business reports? How will companies’ affiliations with other companies change and what are the implications of those changes for the reporting entity of the future? How will technology affect the capacity of reporting entities to provide information and the capacity of users to analyze it? How will technology and changing patterns of producing goods and services change the types of information collected and used for managerial purposes? In what ways will the factors of production change? How will the background, capabilities, and other characteristics of users change? And what are the implications of the answers to the whole range of such questions for the information needs of business report users?

Arriving at answers to such questions will require consideration of the broad trends affecting the reporting environment. The inquiry could include the likely influence of demographics, media penetration, and regulatory activism on accountability obligations; how the mechanisms by which finance is conducted will change; and whether institutions now widely relied on in the business world will gain or lose roles or indeed be supplanted by different institutions. The context could embrace changes in relationships among institutions and their constituents, including changes in the concept of sovereignty and in the future relationships between competing interests, such as between the right to know and the right to confidentiality.

Some who have addressed these kinds of questions and subjects have painted a radically different business reporting environment early in the next century, one with real-time reporting, user access to entity databases, powerful software for users’ analytical tasks, and much lower costs to prepare and disseminate information. Whether or not these predictions become parts of standard setters’ fresh attempts at long-term visioning, they suggest that long-term changes could affect agenda priorities.

The examples just given of the type and breadth of questions that might be addressed in formulating a long-term vision, the forces for change that might be explored, and the dimensions of change that might be revealed are illustrative only. Defining the issues for inquiry obviously would be one of the initial tasks of those who develop the vision. And to ensure its perceptiveness and quality, standard setters should consider assistance from experts in various disciplines — finance, accounting, economics, law, business strategy, behavioral science, and technology, for example.

Recommendation 6

Regulators should consider whether there are any alternatives to the current requirement that public companies make all disclosures publicly available.

The inherent tension between a company’s need for confidentiality and business report users’ perceived right to know is an important issue to address in developing a longer term vision of business reporting. Many expect that tension to increase in the future. On the one hand, the increased availability of information, the increasing complexity of business transactions and relationships, and users’ expectations for more information will provide pressure to disclose more information. On the other hand, competitors will enhance their power to learn from competitively sensitive information and draw advantages from it. This suggests that alternatives to the requirement that public companies make all disclosures publicly available would be relevant to serving the
interests of investors and creditors and improving the allocation of capital.

Under the current requirement of fully public disclosure, all information that goes to users is available to the disclosing companies’ competitors. Fully public disclosure is a valued — even revered — feature of the disclosure system, but it also constrains the types of information that are disclosed because competitive disadvantage is a cost. Yet much information that might cause competitive disadvantage when disclosed to competitors could assist users in their analytical and decision making tasks. The requirement for public distribution of all information thus prevents users from receiving competitively sensitive information that can help them reduce their risks of misallocated capital and improve the effectiveness of capital allocation in the country. A known benefit, the disclosure of useful information to users, is being sacrificed to avoid a known cost, the disclosing company’s competitive disadvantage.

The Committee is not recommending that the fully public disclosure requirement be abandoned, only that regulators explore whether there are any alternatives. Regulators should consider whether the cost of reporting sensitive information to competitors could become an undesirable barrier to providing the most useful information to users and therefore to allocating capital effectively. If so, regulators should consider whether, given such circumstances, it would be in the interest of effective capital allocation for certain users, such as those who agree not to disclose the information, to have access to more extensive information.

The alternatives could be explored in two contexts. The first is the efficient markets theory. Given such markets, are there circumstances where no disservice would be done to the interests of individual investors by allowing professional investors access to more extensive information? Staying with the previous paragraph’s example of confidentiality agreements with users, it would probably be impracticable to reach all users with confidentiality agreements. The most likely candidates for such agreements would be institutional investors, whose full-time attention and transaction volume give them a claim to being the most influential securities price makers. They are far more likely to act rapidly on new information than individual investors. It therefore would be reasonable to inquire whether improved valuations of companies by institutional investors with access to the information under confidentiality agreements would do no disservice to individual investors and creditors, because the share price the individuals consider would reflect the additional information whether or not they had prior access to that information.

The second context for exploring alternatives to the "tell one, tell all" policy is the rapid, ongoing progress of information technology and its influence on the disclosure system. In time, corporate disclosure is likely to be on-line to users. Differential disclosure would then be able to benefit from encryption technology and other devices for selective access to information. There will be many new possibilities to consider, and some can be anticipated now.

Recommendation 7

The AICPA should establish a Coordinating Committee charged to ensure that the recommendations in this report are given adequate consideration by those who can act on them.

Since the Committee formulated this recommendation, the AICPA Board of Directors has voted to establish a Coordinating Committee. According to the Committee's recommendation, the Coordinating Committee should:

- Develop a plan to ensure that the Committee's recommendations are carefully considered by standard setters, regulators, and others.
- Persuade others, including standard setters and regulators, to consider the Committee's recommendations seriously.
- Recommend changes in the roles of standard setters or in the structure or process of standard setting, if necessary, to create an environment that would be supportive of the changes recommended by the Committee.
- Consider whether and how the AICPA should coordinate the efforts of user and preparer groups to find ways for users and preparers who have common needs to agree as a group on the extent and frequency of reporting.
- Consider how to alleviate litigation conditions that discourage companies from making disclosures of forward-looking information.
- Monitor the progress of implementation efforts and encourage those making such efforts to consider
the special concerns that users expressed.

- Consider whether AcSEC should study and recommend to the FASB and SEC longer term changes in business reporting with the goal of helping standards keep pace with major changes in the business environment.

These responsibilities should enable the Coordinating Committee to be a catalyst in bringing appropriate attention to bear on the Committee's recommendations.

Conclusion

The recommendations in this chapter are designed to better the conditions necessary to improve business reporting. As stated at the outset, there is far more to improving business reporting than worthy ideas. Good ideas need to be given force. They must attract attention and support and be differentiated from ideas that can provide no public benefit. They must be considered by those who can turn them into practices and into standards and otherwise implement them. Parties who can influence implementation must cooperate if the ideas are to yield their best results, and they must persevere until all the necessary work is done. Above all, the institutional processes by which improvements are developed and implemented must be effective — oriented to the public interest, focused on the right objectives, open to new ideas, proactive in obtaining needed information, free of needless barriers to progress, and otherwise prepared to fulfill their missions.

Footnotes

I — Summary of Recommendations

This appendix provides a concise listing of the Committee’s recommendations. The rationale and basis for each recommendation are discussed in chapters 5 through 8.

Improving the Types of Information in Business Reporting — Chapter 5

Recommendation 1: Standard setters should develop a comprehensive model of business reporting indicating the types and timing of information that users need to value and assess the risk of their investments.

- The model should be based on certain concepts to guide reporting under the comprehensive model — See appendix II.
- The model should include practical constraints on disclosures to reduce costs when costs could be significant — See appendix II.
- To assess the feasibility of its ideas, the Committee designed and illustrated a comprehensive model based on the above-noted concepts, its understanding of users’ needs for information, and information about costs of reporting — See appendix II.

Recommendation 2: Improve understanding of costs and benefits of business reporting, recognizing that definitive quantification of costs and benefits is not possible.

- See chapter 5 for examples of the types of research to consider.

Financial Statements and Related Disclosures — Chapter 6

Recommendation 1: Improve disclosure of business segment information.

- Basis of segmentation — See appendix II, item I(A)7(a).
- Information to report about segments — See appendix II, item I(A)7(b).
- Restatement of historical segment information when segments change — See appendix II, item I(A)7(c).
- Format of disclosures — See appendix II, item I(A)7(d).
- Information related to unconsolidated entities — See appendix II, item I(A)7(e).

Recommendation 2: Address the disclosures and accounting for innovative financial instruments.

- Broader guidance that addresses fundamental issues is needed. The guidance would provide a framework for addressing the accounting for future innovations in financial instruments, thereby leading rather than lagging behind the pace of change.
- The Committee’s study of users’ needs affirmed the critical importance of improving disclosures and accounting for innovative financial instruments. The FASB is addressing the appropriate issues and it is right to give that work the highest priority.

Recommendation 3: Improve disclosures about the identity, opportunities, and risks of off-balance-sheet financing arrangements and reconsider the accounting for those arrangements.

- The FASB should emphasize disclosures in its projects on unconsolidated entities, special purpose entities, and securitizations.
- The FASB should not reconsider the accounting for leases at this time; however, it should add a limited-scope project to its agenda to improve disclosures by lessees of operating leases.

Recommendation 4: Report separately the effects of core and non-core activities and events, and
measure at fair value non-core assets and liabilities.

- Display of core and non-core activities and events See appendix II, item I(A)4(a):
  - Income Statement
  - Statement of Cash Flows
  - Balance Sheet
- Measurement of non-core assets and liabilities — See appendix II, item I(A)3(a).

Recommendation 5: Improve disclosures about the uncertainty of measurements of certain assets and liabilities.

- Identify in financial statement notes the specific types of assets and liabilities subject to significant measurement uncertainties.
- For assets and liabilities subject to significant measurement uncertainties, disclose how the reported amounts were derived and explain the estimates, assumptions, and judgments about future events considered in their measurement.
- The key to meaningful disclosure is to be selective about the measurement uncertainties disclosed.

Recommendation 6: Improve quarterly reporting by reporting on the fourth quarter separately and including business segment data.

- Fourth-quarter reporting should be no different from the reporting on other quarters except for the disclosure of significant year-end adjustments.
- Notes related to year-end balance sheet amounts can generally be omitted if the fourth-quarter financial statements are included in annual reporting.

Recommendation 7: Standard setters should search for and eliminate less relevant disclosures.

Other recommendations

- Display of information in financial statements
  - In general, companies should increase the amount of detail in financial statements, particularly in the income statement — See appendix II, item I(A)4(b).
- Interim reporting
  - Interim reporting should include quarterly cash flow statements.
  - Interim information should include uncondensed financial statements; however, condensed note disclosures remain appropriate at interim periods.
  - Companies should disclose the methods of computing reported amounts used in interim periods that differ from the methods used at year-end.
- Comparability and consistency of information
  - Companies should restate or reclassify information in more circumstances than allowed in current practice for dispositions, accounting changes, changes on the definitions of business segments, and possibly other items as well if the restated or reclassified information can be assembled reasonably and is necessary for a better and more complete understanding of the business.
  - Standard setters should consider simplifying the procedure for adopting new pronouncements by making them effective for all companies in a single year and prescribing only one method of adoption.
- Key statistics and ratios
  - Companies should provide a summary of key financial and non-financial data on a consolidated basis as well as for each business segment.
  - A company and the users of its business reporting should agree on the periods to be reported for the summary information, which generally need not exceed five years.
- Lower priority issues
  - Standard setters should defer considering issues that have low priority according to the current evidence of users' needs. The Committee's study identified the following five areas that standard setters should not devote attention to at this time:
1. Value-based accounting model.
2. Accounting for intangible assets, including goodwill.
3. Forecasted financial statements.
4. Accounting for business combinations.
5. Alternative accounting principles.

Auditor Association with Business Reporting — Chapter 7

Recommendation 1: Allow for flexible auditor association with business reporting, whereby the elements of information on which auditors report and the level of auditor involvement with those elements are decided by agreement between a company and the users of its business reporting.

- The level of auditor assurance selected for the financial statement element, if any, should determine the maximum level of assurance that could be provided on other elements reported.

Recommendation 2: The auditing profession should prepare to be involved with all the information in the comprehensive model, so companies and users can call on it to provide assurance on any of the model’s elements.

- One standard setter, the Auditing Standards Board, should assume responsibility for new auditing standards.
- Reporting on objective information in the comprehensive model.
  - To the extent possible, current auditing standards should be retained.
  - Existing standards are adequate for auditing and reporting on information in some elements of the model but not others. See chapter 7 for a list of those elements for which existing standards are considered adequate.
- Reporting on subjective information in the comprehensive model.
  - Existing audit guidance is not sufficient, and new standards will be required. See chapter 7 for a list of those elements for which existing standards are not considered adequate.
  - A different (lower) level of assurance from the level provided for information that is verifiable objectively should be expressed using an approach that encompasses the style of current attestation standards as follows: Reasonable basis for presentation. Conformity with presentation standards.
- Standardized reporting.
  - Standardized reporting should be supported.
  - The historical long-form report is not an acceptable alternative to the standardized expression of an auditor’s final conclusion on the fairness of financial statements.
- The Special Committee on Assurance Services and the Auditing Standards Board should pursue the subject of alternative levels of assurance within the Committee’s reporting framework.

Recommendation 3: The newly formed AICPA Special Committee on Assurance Services should research and formulate conclusions on analytical commentary in auditors’ reports within the context of the Committee’s model, focusing on users’ needs for information.

Recommendation 4: The profession should continue its projects on other matters related to auditor association with business reporting.

- Those projects are reporting on internal controls, credibility of business reporting and pressures on auditor independence, and responsibility for detecting fraud.

Facilitating Change in Business Reporting — Chapter 8

Recommendation 1: National and international standard setters and regulators should increase their focus on the information needs of users, and users should be encouraged to work with standard setters to increase the level of their involvement in the standard-setting process.

- Those responsible for standard-setting processes, such as the Financial Accounting Foundation, the
FASB’s parent organization, and standard setters themselves should more effectively recruit users for service on standard-setting boards, advisory councils, and task forces.

- Those responsible for standard-setting processes should seek formal commitments to increase user participation from institutions representing users, such as the Association of Investment Management and Research and the Robert Morris Associates, or major institutional investors and other organizations.
- Those responsible for standard-setting processes should consider novel vehicles to get qualified users to focus exclusively on users’ needs for the benefit of the standard-setting process (for example, focus groups and task forces made up of recently retired users).
- Standard setters should more aggressively search for, sponsor, and undertake research about how users make decisions and about the relative usefulness of various types of information in their decision making processes.
- Standard setters should become more active in helping steer research programs into areas that are relevant to the standard-setting process.

Recommendation 2: U.S. standard setters and regulators should continue to work with their non-U.S. counterparts and international standard setters to develop international accounting standards, provided the resulting standards meet users’ needs for information.

- Any approach that would sacrifice users’ needs for information to the goal of creating international standards should be rejected.
- A policy of mutual recognition should be rejected, except when the differences among disclosure presentations are immaterial.

Recommendation 3: Lawmakers, regulators, and standard setters should develop more effective deterrents to unwarranted litigation that discourages companies from disclosing forward-looking information.

- Legislators and regulators should create more effective safe harbors and should adopt other measures that discourage unwarranted litigation.
- Standard setters should reduce the threat of unwarranted litigation by developing provisions for forward-looking disclosures that enable companies to demonstrate compliance.

Recommendation 4: Companies should be encouraged to experiment voluntarily with ways to improve the usefulness of reporting consistent with the Committee’s model. Standard setters and regulators should consider allowing companies that experiment to substitute information specified by the model for information currently required.

Recommendation 5: Standard setters should adopt a longer term focus by developing a vision of the future business environment and users’ needs for information in that environment. Standards should be consistent directionally with that long-term vision.

- Standard setters should have some systematic approach to awareness of the likely importance of economic and technological changes for business reporting so that agenda priorities are well chosen, resources are effectively deployed, and standards are appropriate to the environment in which they are to be applied.
- To ensure the perceptiveness and quality of their vision, standard setters should consider assistance from experts in various disciplines — finance, accounting, economics, law, business strategy, behavioral science, and technology, for example.

Recommendation 6: Regulators should consider whether there are any alternatives to the current requirement that public companies make all disclosures publicly available.

- The fully public disclosure requirements should not be abandoned; however, regulators should explore whether there are any alternatives.
- Regulators should consider whether the cost of reporting sensitive information to competitors could become an undesirable barrier to providing the most useful information to users and therefore to
allocating capital effectively.

Recommendation 7: The AICPA should establish a Coordinating Committee charged to ensure that the recommendations in this report are given adequate consideration by those who can act on them.

- The Coordinating Committee should be responsible for the activities listed in chapter 8.
RESPONSIVE TO THE INFORMATION NEEDS OF INVESTORS AND CREDITORS AS UNDERSTOOD BY THE
AICPA SPECIAL COMMITTEE ON FINANCIAL REPORTING

Overview

The following is a comprehensive model of business reporting (the model) based on the Committee's understanding of the information needs of investors and creditors (users) in making rational capital-allocation decisions related to for-profit companies. Reporting under the model would promote an efficient capital-allocation process, which is critical for a healthy economy.

Standard setters long have recognized the usefulness of models or frameworks. However, existing models focus on financial statements rather than on the broad range of users' information needs. The model, based on the key concepts noted below, was designed to help focus attention on a broader, integrated range of information and provide the foundation for future improvements to business reporting. The model does not satisfy all of the users' needs for information. Rather, it provides only that portion of information that is within management's expertise and for which management is the best source and which can be provided at acceptable costs. Information in the model would replace, not be in addition to, much of the information currently contained in annual and quarterly reports and filings with the SEC.

The model provides information that is both reliable and relevant by expanding, reorganizing, and changing the information currently provided by business reporting and is flexible in its application by reporting entities. It is designed to provide information that fits into the decision processes that many investors and creditors use to make forecasts, value companies, or assess the prospect of repayment. Specialized accounting and reporting requirements that may apply to different industries are not addressed. For example, although the model suggests that interest expense would be excluded from core activities, a financial services company would likely include certain interest activity in its core activities. As such, specific applications of the concepts of the model will vary among industries and even among companies within an industry.

Although the model is responsive to the needs of users, the reporting requirements have been tempered to address companies' concerns about costs of preparation and dissemination (at a time when many companies are downsizing and streamlining operations), of disclosing competitively sensitive information, and the potential for increased litigation. More specifically, the model includes the following constraints on disclosure to reduce costs when costs could be significant:

- Business reporting should exclude information outside of management's expertise or for which management is not the best source, such as information about competitors.
- Management should not be required to report information that would significantly harm the company's competitive position.
- Management should not be required to provide forecasted financial statements. Rather, management should provide information that helps users forecast for themselves the company's financial future.
- Other than for financial statements, management need only report the information it knows. That is, management should be under no obligation to gather information it does not have, or need, to manage the business.
- Certain elements of business reporting should be presented only if users and management agree they should be reported — a concept of flexible reporting.
- Companies should not have to expand reporting of forward-looking information until there are more effective deterrents to unwarranted litigation that discourages companies from doing so.

The Committee believes that its recommendations are sufficiently cost-beneficial to merit consideration by standard setters, who would — as a matter of course — perform further cost and benefit analysis as part of their due process.
Key Concepts

To assess the feasibility of its ideas, the Committee designed and illustrated the model based on the following key concepts.

- **Allow for flexible reporting.** The model includes ten elements within five broad categories of information. The elements provide a menu of choices that allows for flexible reporting. Because users differ in their needs for information, not all companies should report all elements of the model. Rather, companies should report only those elements of the model that users need in the particular circumstances. Requiring all companies to report all elements would result in excessive costs and, in many circumstances, provide more information than is needed. Business reporting should include at least the financial statement element and such other elements of the model as users and the reporting entity agree should be provided in the particular circumstances. Since regulators already require much of what is included in the model, they probably would choose to receive from public companies most, if not all, of the model's elements. On the other hand, non-public company owners and lenders probably would limit reporting to the specific elements required for their purposes.

- **Report separately on each business segment of a company's business having diverse opportunities and risks.** Multisegment companies operate diverse businesses that are subject to different opportunities and risks. Many users view business segments as the engines that generate future earnings or cash flows and, thereby, drive returns on investments. Segment information provides additional insight into the opportunities and risks of investments and sharpens predictions. For a company with more than one business segment, most types of information specified by the model apply to the business segment level. Because of its predictive value, improving segment reporting is of the highest priority.

- **Explain the nature of a company's businesses, including the linkage between events and activities and the financial impact on a company of those events and activities.** Users that follow fundamental approaches of analysis need to understand the nature of a company's businesses. The nature of a business refers to the types of products or services offered, the methods of producing or delivering those products or services, the number and types of suppliers and customers, the locations of facilities and markets, and other factors that describe the activities of a business. Understanding the linkage between events and activities and the financial impact on a company of those events and activities is a critical part of understanding a business. Users recognize that financial results are a consequence of a company's business activities and events.

- **Provide a forward-looking perspective.** Users focus on the future while today's business reporting focuses on the past. Although information about the past is a useful indicator of future performance, users also need more forward-looking information.

- **Provide management's perspective.** Many users want to see a company through the eyes of its management to help them understand management's perspective and predict where management will lead the company.

- **Indicate the relative reliability of information in business reporting.** The usefulness of information is a function of its relevance and its reliability. Users obviously need information that is most relevant to their purposes. They also need information to be as reliable as possible. However, users also need to be able to distinguish between information that is highly reliable and that which is less reliable — that is, they need to understand the measurement uncertainty of less reliable information.

- **Focus on measurement to help users understand a company's performance relative to that of competitors and other companies.** While descriptions of business events are important, numbers are important too. Management should disclose the measurements it uses in managing the business that quantify the effects of key activities and events.

- **Promptly communicate important changes affecting a company.** Reporting under the model should be prompt and at least quarterly. For critical transactions and events, information should be reported within a few days of the transaction or event. In the future, reporting should be made ever more prompt as the rate of change in business activities accelerates and as information technology reduces the cost of collecting and providing updated information.

- **Communicate effectively and efficiently.** The information should be communicated to the users in the most effective and efficient manner. For some users, the information will continue to be transmitted on paper. Others may access the information in electronic form. To the extent possible, the information in the model should be supplemented with charts and graphs to improve and speed up users' comprehension of the information. Those charts and graphs should follow...
presentation standards to ensure that they fairly present the information that is comparable among companies.

- **Consider the costs and benefits of business reporting.** Standard setters and regulators should continue to be sensitive to the costs of business reporting and should search for ways to limit the costs of reporting while still providing more useful information.

The Committee's recommendations also seek to improve the credibility of business reporting by including elements that help ensure balanced, neutral, and unbiased reporting. Those elements include (a) the reporting of risks as well as opportunities, (b) the focus on measurements rather than only qualitative discussion, (c) the comparison of actual business performance to previously disclosed forward-looking information, and (d) reporting about the uncertainty of reported measurements.

**Differences Between the Model and Business Reporting by U.S. Public Companies**

The Committee's model differs from current reporting by U.S. public companies to the SEC in the areas described below.

- **Business segment perspective.** The model focuses more on reporting at the segment level than does reporting in current practice. It encourages companies to report on more business segments, and it reports a broader array of information at the segment level, such as management's analysis. It also encourages flexible standards that limit, in certain circumstances, disclosures of geographic segment information.

- **Financial statements.** The model generally retains the form and content of today's financial statements and footnote disclosures. However, the Committee developed several recommendations to improve financial statements, as discussed in the following section.

- **High-level operating data and performance measurements.** The Committee's model includes high-level operating data and performance measurements that management uses to manage the business. With certain exceptions, U.S. public companies currently are not required to report that type of information, although many voluntarily provide substantial information of this type. High-level operating data and performance measures will vary by industry and by company. Management should identify measures it believes are significant and meaningful to its business and that are leading indicators of a company's future.

- **Management's analysis.** Management's analysis in the model differs in important respects from that in current practice. For example, management's analysis in the model addresses trends and changes in operating data and performance measures as well as trends and changes in financial statements. Current practice focuses on changes in financial data. Further, management's analysis in the model addresses separately the performance of each industry segment within a multisegment company. Current practice does not require analysis at the segment level.

- **Forward-looking information.** Business reporting currently focuses on information about the past. In contrast, the model calls for a balance of reporting between past and forward-looking information. However, the model does not require projections or forecasts. It defines forward-looking information as: (a) opportunities and risks, including those resulting from key trends; (b) management's plans, including critical success factors; (c) comparison of actual business performance to previously disclosed forward-looking information. The SEC already requires, in MD&A, disclosures about opportunities and risks. The model, however, elevates disclosure about opportunities and risks to a separate element of the business report and provides a framework for the disclosure.

- **Background about the company.** The model divides information in the background category into three elements: (1) broad objectives and strategies, (2) scope and description of business and properties, and (3) impact of industry structure on a company. Current practice already requires disclosures in the scope and description of business and properties category. The Committee's model for that type of information is substantially consistent with that practice. Current practice does not require information for the remaining elements, although public companies often voluntarily discuss their objectives and strategies in business reporting.

**Improvements in Financial Statements**

Although the model generally retains the form and content of today's financial statements and related disclosures, it
includes certain changes that affect display, measurement, disclosure, summary data, and interim reporting.

- **Financial statement display.** The model distinguishes between the effects of core and non-core activities. Core activities are usual (ordinary and typical) and recurring (expected to occur again after an interval) activities, transactions, or events and continuing operations; obbusiness(es) that management does not intend to discontinue or abandon; cb, excluding interest. Most users’ concept of core excludes interest, particularly in valuing companies and assessing credit risk. However, for financial services entities and the like, a portion of, if not all, interest activity would likely be included in core earnings. The concept of non-core is described as unusual (abnormal activities or those that are unrelated to the ordinary and typical operations of the entity) or non-recurring (not expected to occur again after an interval) activities, transactions, or events or discontinued operations; obbusiness(es) that management intends to discontinue or abandon; cb. Companies should distinguish between core and non-core earnings on the face of the income statement, and between core and non-core cash flows on the cash-flow statement. Further, companies should separately display non-core assets and liabilities on the balance sheet. The model calls for per share measures related to both core earnings and net income, and it permits per share measures related to cash flows. In general, the model calls for more detailed captions either on the face of the statements or in the notes, compared to the level of detail displayed in current practice.

- **Measurement.** The model retains the current mixed-attribute rules for measurement of assets and liabilities, with the exception of those that result from non-core activities. These non-core assets and liabilities should be measured at fair value. Changes in unrealized appreciation or depreciation in those assets or liabilities are charged or credited directly to shareholders’ equity.

- **Disclosure of disaggregated information.** At a minimum, companies should report business segments on an industry basis. Segment disclosures on a geographic basis should also be reported if materially disparate business opportunities and risks exist. Some companies in certain circumstances should report business segments on other bases, such as line-of-business or individual products, if those are materially different opportunities and risks. In general, companies would report on more industry segments under the model than they report on in current practice. They would also report more information about unconsolidated entities. In concept, users would like complete financial statements for each industry and geographic segment. However, as a practical matter, companies may limit their disclosures to the few key statistics that are the minimum necessary for the user to understand the business. In general, users will require more detail about the income statement than the balance sheet. However, users need disaggregated balance sheet and cash-flow information, which should be disclosed if it is available to the company.

- **Other disclosures.** Pending resolution by standard setters of issues involving recognition and measurement of financial instruments and off-balance-sheet financing arrangements, the model calls for more disclosures about the risks associated with those instruments and arrangements. Also, for assets and liabilities that are subject to significant measurement uncertainties, companies should describe how the amounts were derived and explain the estimates, assumptions, and judgments made in measuring the underlying asset or liability. Finally, companies should disclose the rationale used to distinguish core earnings and non-core activities, although appropriate accounting standards will need to be established to allow for useful and meaningful disclosures.

- **Summary information and restatement of financial data.** The model calls for a summary of selected financial and non-financial data on a consolidated basis as well as for each industry segment. That data would include, among others, sales, gross margin percentage, core earnings, and ratios related to financial position. The period or periods of key statistics and ratios to be presented should be agreed upon by users and the reporting entity, but generally should not exceed five years. Financial data should be restated or reclassified for dispositions, accounting changes, changes in the definition of an industry segment, and possibly other items as well if the restatement or reclassification information can be reasonably assembled and is necessary for a better and more complete understanding of the business. Otherwise, restatement or reclassification is not required.

- **Interim reporting.** Interim information should be provided at least quarterly and should consist of uncondensed financial statements, although condensed footnotes are often appropriate. Disaggregated information should be reported on an interim basis, consistent with the information provided in the annual presentation. Quarterly reporting should include quarterly cash-flow statements. Fourth-quarter reporting should be no different than that for the other quarters, except
for the disclosure of significant year-end adjustments.

Model of Business Reporting — Major Components

I. Financial and Non-Financial Data
   (A) Financial statements and related disclosures
   (B) High-level operating data and performance measurements that
       management uses to manage the business

II. Management's Analysis of Financial and Non-Financial Data
   (A) Reasons for changes in the financial, operating, and
       performance-related data, and the identity and past effect of
       key trends

III. Forward-Looking Information
   (A) Opportunities and risks, including those resulting from key
       trends
   (B) Management's plans, including critical success factors
   (C) Comparison of actual business performance to previously
       disclosed opportunities, risks, and management's plans

IV. Information About Management and Shareholders
   (A) Directors, management, compensation, major shareholders, and
       transactions and relationships among related parties

V. Background About the Company
   (A) Broad objectives and strategies
   (B) Scope and description of business and properties
   (C) Impact of industry structure on the company

Model of Business Reporting — Details Within Major Components

I. Financial and Non-Financial Data
   (A) Financial Statements and Related Disclosures
      1. Periods to Be Reported, Restatement, and Summary Information
         a. Consistent with the flexible reporting feature of the
            model, financial statements and related note disclosures
            should be reported for a period or periods agreed upon by
users and the reporting entity.

b. Financial information should be restated or reclassified for all material business combinations, dispositions, accounting changes, changes in the definition of an industry segment, and possibly other items as well, if the restatement or reclassification information can be reasonably assembled and is necessary for a better and more complete understanding of the business. Otherwise, restatement or reclassification is not required.

c. The model calls for a summary of key statistics and ratios. The statistics would include, among others, sales, gross margin percentage, core earnings, and ratios related to financial position. The period or periods of key statistics and ratios to present should be agreed upon by users and the reporting entity, but generally should not exceed five years.

2. Types of Financial Statements

a. The model includes three financial statements: (1) statement of financial position, (2):NSP:statement of income, and (3) statement of cash flows.

b. An analysis of changes in shareholders' equity is also required. However, that analysis can be included in the notes to the statements. It need not be a separate statement.

c. The model retains the form and content of today's financial statements and note disclosures except as specified in I(A)3 through I(A)8.

3. Measurement

a. The model retains the current mixed-attribute rules for measurement of assets and liabilities, with the exception of those that result from non-core activities. Non-core assets and liabilities should be measured at fair values. Changes in unrealized appreciation or depreciation in non-core assets or liabilities are charged or credited directly to shareholders' equity.

b. Net income is measured the same as in current GAAP.

4. Display

a. Report separately the effects of core and non-core activities and events. The goal of distinguishing, on the face of the financial statements, between the effects of core and non-core activities is to present the best possible information with which to analyze trends in a company's business.

A company's core activities are usual and recurring activities, transactions, or events and continuing
operations, excluding interest. Usual means that the activity is ordinary and typical for a particular company. Recurring means that the activity, transaction, or event is expected to occur again after an interval. Core activities include usual and recurring operations and recurring non-operating gains and losses.

Conversely, non-core activities, transactions, or events are unusual (not typical for a particular company) or non-recurring (not expected to occur again in the foreseeable future or before a specified interval). Examples include:

- Discontinued operations (businesses that management intends to discontinue or abandon).
- Unusually large transactions that are not expected to recur in the foreseeable future.
- The effects of a rare natural disaster.
- Unique transactions, such as selling real estate by a company that rarely sells real estate.
- The effects of changes in accounting principles.

The term core activities is sometimes used in the Business community to mean major, critical, or central Operations as opposed to emerging or peripheral operations. It is not intended for the concept of core earnings to narrowly represent the major, critical, or central operations of a company, but rather the broad usual and recurring activities for the company as a whole (including emerging or peripheral operations). In fact, there may be a presumption that all operations of the company are core unless considered otherwise by management. Furthermore, most users' concept of core excludes interest when valuing companies and assessing credit risk. However, for financial services entities and the like, a portion of, if not all, interest activity would likely be included in core earnings. It is important to include disclosures surrounding management's rationale used to distinguish core earnings and non-core activities, transactions, or events, although appropriate accounting standards must be in place to allow for useful and meaningful disclosures.

(i) **Income Statement:** Core earnings are not a prediction of future earnings. Rather, core earnings are historical earnings adjusted to exclude the effects of historical unusual or non-recurring items. The goal of presenting core earnings is not to present an estimate of normal income or recurring income. Neither core earnings be averaged or artificially smoothed. The core earnings of a business that is inherently
cyclical or volatile should appear cyclical or volatile—not smooth.

Distinguishing between core and non-core earnings would require the following changes in current practice:

- The statement should present two categories of earnings in the following order: (1) core and (2) non-core and financing costs.

- Interest income and expense should be relocated from a component of pre-tax income to the section below core earnings under financing costs. Gains and losses from extinguishment of debt should be relocated from extraordinary items to a component of financing costs and should be separately disclosed.

- The effects of unusual or non-recurring transactions or events should be separately displayed as a component of non-core income. Amounts in the unusual or non-recurring category should be reclassified from revenues, expenses, gains, and losses.

- Discontinued operations is defined in current practice as a component of a company whose activities represent a separate major line of business or class of customer. That definition should be broadened to include all significant discontinued operations whose assets and results of operations and activities can be distinguished physically and operationally and for business-reporting purposes.

- Extraordinary items should be eliminated. The concept is too narrow to be useful and is redundant with the unusual or non-recurring category. Items classified as extraordinary should be classified as unusual or non-recurring transactions or events, or financing costs if related to debt.

- At a minimum, companies should provide share data related to core earnings, non-core income or expense and financing costs, and net income. Other share data also may be provided.

(ii) Statement of Cash Flows: Distinguishing between core and non-core cash flows would require the following changes in current practice:

- The cash flows from the operating activities portion of the statement of cash flows should present two categories of cash flow in the
following order: (1) core and (2) non-core and financing costs.

- Net cash flows from core activities plus cash flows from non-core activities and financing costs should total to net cash provided by the operating activities.

- The model proposes no changes to the investing and financing sections of the statement of cash flows. In concept, however, the investing and financing sections could also separately display core and non-core cash flows, although the incremental insight from that display would not justify the increased complexity of the cash-flow statement and the cost of preparing the information.

- The model permits disclosure of core cash flows per share.

(iii) **Balance Sheet**: The model calls for companies to distinguish, on the face of the balance sheet, between core assets and liabilities and non-core assets and liabilities. Core assets and liabilities result from a company’s usual and recurring activities, transactions, or events. Conversely, non-core assets and liabilities result from unusual or non-recurring activities, transactions, or events.

- Non-core assets include for example:
  - A receivable related to an unusually large sale of product that is not expected to recur in the foreseeable future.
  - Real estate held for investment by a company that only rarely invests in real estate.

- Non-core liabilities include for example:
  - Liabilities that are closely associated with non-core assets, such as a mortgage liability related to non-core real estate.
  - A contingent liability related to a discontinued business.

b. Companies should increase the amount of detail in the statements, particularly in the income statement, as a means of helping users understand the business, the linkage between the financial statements and actual events, and the opportunities and risks. More specifically, companies should consider the following:

- Dividing operating expenses into fixed and variable, or controllable and non-controllable, or discretionary
and non-discretionary categories.

- Disclosing the portions of cost-of-sales that relate to purchased materials, salaries, fringe benefits, occupancy costs, property taxes, and other major components of costs.
- Disclosing selling expenses separately from general and administrative expenses.
- Disclosing the portion of cost-of-sales and SG&A expenses that is depreciation.
- Disclosing the portion of costs and expenses that relate to employees versus those that do not.
- Disclosing the cash versus the non-cash parts of unusual expenses.
- Disclosing details of the equity income line item.
- Disclosing amortization separately from depreciation.
- Disclosing the components of capital expenditures, distinguishing between capital expenditures that are essential to maintaining the business and those that could be postponed; those that enhance a company's productive capacity versus those that do not; and those that are required by regulation, such as pollution control equipment, and those that are not.
- Providing more detail of items in other assets and other deferred charges and credits, using a lower materiality threshold than is currently used in practice.
- Displaying separately past-due receivables or an aging of receivables.
- Displaying separately slow-moving inventory or an aging of inventory.
- Providing more details about the nature of and changes in valuation reserves.

5. Classification
   a. The statement of financial position should retain the current and non-current classification of assets and liabilities as presently provided in generally accepted accounting principles.

6. Disclosure
   a. More qualitative and quantitative information about the risks associated with financial instruments and off-balance-sheet financing arrangements (for example,
hedging strategy, sensitivity analysis to interest and
foreign exchange rates, credit, and counterparty risks on
derivatives).

b. The historical costs, fair values, and methods and
assumptions used in determining the fair values of
non-core assets and liabilities.

c. The footnotes should disclose a company's accounting
policies used to distinguish between core and non-core
income or expense and the details of the individual items
included in captions on the income statement. For example,
the accounting policies footnote should discuss a
company's policy for determining unusual and non-recurring
transactions or events. The footnotes should also
identify, describe, and quantify the effects of each
individually significant transaction or event that is
classified as unusual or non-recurring.

d. With respect to specific financial statement items, a
statement that uncertainties are inherent in measuring
those financial statement items because estimates,
assumptions, and judgments are necessary in determining
their reported amounts.

e. Identify in financial statement notes the specific types
of assets and liabilities subject to significant
measurement uncertainties.

f. For those assets and liabilities subject to significant
measurement uncertainties, disclose how the reported
amounts were derived and explain the estimate's
assumptions and judgments about the future events
considered in their measurement.

7. Disaggregated Information

a. **Basis of Disaggregation**: Companies should determine the
segments to be reported based on opportunities and risks:
activities having similar opportunities and risks should
be aggregated while those having diverse opportunities and
risks should be reported as separate segments. At a
minimum, however, companies should provide disaggregated
information on an industry basis. Segment disclosures on a
geographic basis should also be reported if materially
disparate business opportunities and risks exist. Further,
companies should provide disaggregated information for
line-of-business or individual products if they are
critical drivers of the company's opportunities and
risks.

(i) **Disaggregation Based on Industry**: The model does not
propose changes to the concept or definition of
industry segments as currently defined in Statement
14. However, standard setters should consider
practical devices that will help companies define
their product and service groupings more narrowly and
disclose information about more industry segments.

The primary means to improving industry segment reporting should be alignment of business reporting with internal reporting. That is, to the extent possible, companies should define industry segments for business reporting in a manner consistent with their definitions for internal reporting to senior management or the board of directors. The fact that a company defines industry segments more narrowly for internal reporting to senior management than it does for business reporting strongly suggests that it should expand the number of segments reported externally.

In addition to aligning business reporting with internal reporting, standard setters should consider the following practical devices that should help companies define their industry segments more narrowly. In deciding on industry segments, companies should:

- Consider the way in which companies carry out their business activities. The fact that certain products or groups of products require different or specialized functions within the company suggests that the company is in multiple segments. For example, the fact that a dedicated marketing team supports one group of products but not others suggests that group may be a reportable segment.

- Look to the manner in which analysts attempt to segment the company in their published reports. If the company is not followed by analysts, it should look to the manner in which analysts attempt to segment their publicly held competitors.

- Look to the industry segment definition used by competitors. Competitors reporting separate segments for industries in which the reporting company participates suggests the segments to be reported. However, a company should not use the reporting practices of competitors to justify reporting fewer segments as that practice results in lowest-common-denominator reporting.

- Not need to report on more than eight to ten industry segments.

(ii) Disaggregation Based on Geographic Location: Because the usefulness of geographic segment information varies, flexible standards should be considered by standard setters. Those standards should:

- Require geographic segment information only when it provides insight into the opportunities and risks a company faces.
o Require that companies consider disclosures of geographic segment information based on market locations or operating locations or both, depending on which bases provide insight about opportunities and risks.

o Not specify the geographic regions to be reported. Rather, companies should group locations based on the groupings that provide the most insight into opportunities and risks, which may result in groupings smaller or larger than countries.

o Require that companies consider disclosing geographic segment information for each industry segment, rather than geographic information for all of a company's activities in a location, if that method provides greater insight into the opportunities and risks for the industry segments.

o Align, to the extent possible, geographic segment information reported externally with information reported internally to senior management or the board of directors.

b. *Disaggregated Information to Be Provided:* In concept, users would like complete financial statements for each industry and geographic segment. However, as a practical matter, companies should be allowed to limit segment disclosures to those key financial statistics that a company has available (with the exception of revenues and cost of revenues which should be reported at a minimum). A statistic is available to a company if it is used for internal reporting purposes or if information already captured by the company's system can be aggregated to develop the statistic, without arbitrary allocations. In general, users will require more detail about the income statement than the balance sheet. However, users need disaggregated balance sheet and cash-flow information, which should be disclosed if it is available to the company.

Standard setters should reconsider the key statistics to be reported for segments, including whether the statistics should vary by industry or sector. In addition, standard setters should consider whether the key statistics should be expanded beyond those now required to include:

- Gross margin or some other statistic, to help users understand the segment's operating leverage.
- Cash-flow statistics, to assist those users that focus on cash flows.
- Improved disclosure about the effects of unusual or non-recurring items, to help users identify core
earnings or cash flows.

- Working capital, to help users understand the segment's need for capital.

- Research and development costs, to help users understand the segment's commitment and need to develop new products, services, or processes.

- Major classes of assets, such as receivables, inventories, and property, plant and equipment, to help users assess the segment's need for capital and evaluate opportunities and risks.

In specifying the computation of the key statistics, standard setters should not require arbitrary allocations of revenues, expenses, assets, or liabilities. Rather, standard setters should allow companies to report the statistic on the same basis it is reported for internal purposes, if the statistic is reported internally. Segment reporting should apply to all multisegment companies (public or private).

c. **Restatement of Historical Disaggregated Information When Segments Change**: Companies frequently change the definitions of industry and geographic segments. Disaggregated information should be restated or reclassified for changes in the definition of an industry segment if the restatement or reclassification information can be reasonably assembled and is necessary for a better and more complete understanding of the business. Otherwise, restatement or reclassification is not required.

d. **Format of Disclosures**: Companies should report disaggregated information in a format that reconciles the disaggregated information to the corresponding aggregated total. Often, that reconciliation will include an "other" segment that includes those businesses or geographic regions that individually do not meet the criteria for disclosure as a separate segment.

e. **Disaggregated Information Related to Unconsolidated Entities**: 

- The equity method of accounting should be retained because alternative methods offer no advantages.

- The notes to the financial statements should include more information about unconsolidated investees in general, and significant investees in particular. The SEC should consider lowering its threshold test for determining which investees are deemed to be significant.

- The need for information about investees is similar to
8. Interim Reporting

a. Disaggregated information should be reported on an interim basis, consistent with the information provided in the annual presentation.

b. When interim information is reported, the company and user of the information should negotiate and agree on the frequency (however, users of public company business reporting believe that interim information should be provided at least quarterly).

c. Quarterly reporting should include quarterly cash-flow statements.

d. Companies should report fourth-quarter information even if that information is released concurrently with annual reporting. Fourth-quarter reporting should be no different from that for other quarters except for the disclosure of significant year-end adjustments. Footnotes related to year-end balance sheet amounts can generally be omitted if the fourth-quarter financial statements are included in annual reporting.

e. Interim information should consist of uncondensed financial statements. However, condensed footnotes are often appropriate, except for fourth-quarter balance-sheet information included in an annual report.

f. When applicable, disclosures should state that certain interim amounts are derived by estimation methods that may cause these amounts to be less reliable at interim dates than they are at year-end when the reported amounts are based on more refined estimation methods. Companies should also disclose the interim assumptions and methods that differ from annual calculations.

(B) High-Level Operating Data and Performance Measurements That Management Uses to Manage the Business

High-level operating data and performance measurements will vary by industry and company. Management should identify those measures that it believes are significant and meaningful to its business, and that are leading indicators of the company's future.

Non-financial information is important to understanding a company, its financial statements, the linkage between events and the financial impact on the company of those events, and predicting the company's future. For companies with more than one segment, such information should be reported at the segment level. Generally, the following disclosures of non-financial information
would be of quantitative measurements, assuming those measurements are sufficiently reliable for external presentation; however, companies should supplement quantitative measurement disclosures with qualitative discussions where meaningful. To the extent non-financial information is not known to the company or is considered insignificant to understanding its operations and to an understanding of the company, and its financial statements, disclosure is not required.

The information should be presented for the same period(s) as the financial statements and the summary of key statistics and ratios. Information such as the following should be considered for disclosure:

- Statistics related to activities that produce revenues, market acceptance, and quality, such as units and prices of product or services sold; growth in units sold or average prices of units sold; growth or shrinkage in market share; measures of customer satisfaction; percentage of defects or rejections; and backlog.

- Statistics related to activities that result in costs, such as the number of employees and average compensation per employee, and the volume and prices of materials consumed.

- Statistics related to productivity, such as the ratio of outputs to inputs.

- Statistics related to the time required to perform key activities, such as production or delivery of products or services and developing new products or services.

- Statistics related to the amount and quality of key resources, including human resources, such as the average age of key assets, or the quantity of proved reserves of natural resources.

- Measures related to innovation, such as the percentage of units produced in the current year that were designed within the last three years, or the number of suggestions to improve businesses processes received from employees in the last year.

- Measures of employee involvement and fulfillment, such as employee satisfaction and the rate of change in that measure.

- Measures of strength in vendor relationships, such as vendor satisfaction, and the rate of change in that measure.

II. Management's Analysis of Financial and Non-Financial Data

(A) Reasons for Changes in the Financial, Operating, and Performance-Related Data and the Identity and Past Effect of Key Trends

This section identifies key changes in amounts in the historical financial statements and non-financial statistics and discusses
the reasons for those changes. The explanations thus serve as the non-financial counterpart to the financial statements. That is, just as the financial statements explain what happened in a financial sense, the explanations of changes explain what happened in a non-financial business sense. For annual reporting, management’s analysis of the data should focus on at least the last year. The explanations should address at least the areas described below.

1. Reasons for Changes
   a. Market acceptance, such as the changes in revenues resulting from changes in prices, changes in volumes, and new products or services, and the reasons for those changes.
   b. The reasons for changes in ratios, such as the ratio of outputs to inputs.
   c. Innovation, such as the percentage of revenues resulting from products that did not exist within the last three years, or the percentage reduction in costs resulting from new processes, and the reasons for changes in those percentages.
   d. Profitability, such as the ratio of net income to sales and the reasons for changes in that percentage.
   e. Changes in financial position, such as the number of days sales in receivables and the reasons for changes in that number.
   f. Liquidity and financial flexibility, such as the ratio of debt to equity and the reason for the change in that ratio.
   g. Identity and effect of unusual or non-recurring transactions and events included in financial statements.

2. The Identity and Past Effect of Key Trends
   a. The identity of social, demographic, technological, political, macroeconomic, and regulatory trends that management has identified and believes have significantly affected the business.
   b. The past effect of each trend identified in II(A)2(a) if management has formed a conclusion about that impact.

III. Forward-Looking Information

Although prospective financial and non-financial information is often useful for financial analysis, users often prepare it themselves and it is not a required part of the reporting model for cost-benefit reasons. If presented, prospective data are not a substitute for the other elements of the model. If management elects to present prospective information, the presentation should meet minimum
standards, such as the AICPA's standards for reporting forecasts. In reporting forward-looking information, the following elements should be considered.

(A) Opportunities and Risks, Including Those Resulting from Key Trends

Opportunities and risks are characterized as material trends;obas identified in II(A)2(a);obas, demands, commitments, concentrations, and events, including legal proceedings, known to management that would cause reported financial information not to be necessarily indicative of future core earnings, net income, cash flows, or of future financial conditions.

1. The nature of each opportunity or risk that meets the disclosure criteria in III(A)4, and the identity of the trend, demand, commitment, or event, including legal proceedings, that gives rise to it should be disclosed.

2. For each opportunity or risk identified in III(A)1, disclose the effects, if any, on the business's future core earnings and future core cash flows. The disclosures should be made separately for each class of opportunities or risks described in III(A)4 that are applicable to the business's circumstances.

3. Disclosures about the risk of illiquidity should focus on financial flexibility: that is, the ability of an entity to adjust its future cash flows to meet needs and opportunities, both expected and unexpected. More specifically, the disclosures should:

   a. Identify and describe internal and external sources of liquidity and material unused sources of liquid assets.

   b. Describe any known trends, favorable or unfavorable, in the type, amount, sources, or cost of capital that the company or segment is able to attract.

   c. Identify known trends, commitments, events, or uncertainties that are reasonably likely to result in the company's or segment's liquidity increasing or decreasing in a material way. If a material deficiency is identified, indicate the course of action that the company or segment has taken or will take to remedy the situation.

4. Companies should disclose the information in III(A)1 through III(A)3 for each opportunity and risk that meets all of the following criteria at the reporting date:

   (a) **Current Exposure**: The opportunity or risk should not develop wholly in the future.

   (b) **Important Concern**: Where a trend, commitment, concentration, or event, including legal proceedings, is known, management should consider three factors: likelihood of occurrence, magnitude of potential impact,
and imminence of potential impact.

Management should consider the three factors together to determine if the opportunity or risk is sufficiently important to result in disclosures that are useful to investors and creditors. Disclosure becomes more useful (1) as the likelihood that the trend, commitment, concentration, or event will come to fruition grows; (2) as the magnitude of potential impact on financial position, core earnings, net income, comprehensive income, or cash flows increases; and (3) as the potential impact comes nearer to the occurrence. Management should follow the following guidelines in applying the concept in this paragraph.

- Disclosure is required if it is probable that the known trend, demand, commitment, or event will come to fruition, and if the potential impact is at least material.

- Disclosure is generally not required if the likelihood of occurrence is remote. Disclosure is required, however, if the magnitude of the potential impact is severe, such as one that would threaten the company's ability to survive.

- Disclosure is required if the potential impact could seriously disrupt or dramatically change the company's operations, and if the likelihood of occurrence is greater than remote.

- Imminence of potential impact is the least important of the three factors. Generally, disclosure should be limited to opportunities and risks that could affect the company within the foreseeable future, although generally not for a period beyond three years from the balance-sheet date.

- Management may be unable to determine the likelihood of occurrence, the magnitude of potential impact, or the imminence of potential impact. If management cannot make that determination, it should evaluate whether disclosure would be useful on the assumption that the occurrence is probable, the magnitude is large, or the impact is imminent.

(c) **Specific or Unusual Exposure**: The opportunity or risk should be specific to the entity or the entity should be unusually exposed to a material trend, demand, commitment, concentration, or event, including legal proceedings, that is abnormal and significantly different than the ordinary environment in which the company operates.

(d) **Helps Estimate Cash Flows or Earnings**: A lack of disclosure must adversely affect the ability of users to estimate future cash flows or earnings.
(e) Limited to opportunities and risks that have been identified and considered by management in the operation of the business.

5. In identifying risks and opportunities that meet the disclosure criteria, companies should consider the following classes of risks and opportunities:

   o Opportunities and risks resulting from participation in additional industries.
   
   o Opportunities and risks resulting from changes in the segment's industry structure. The components of industry structure are listed in V(C).
   
   o Opportunities and risks resulting from concentrations (for example, concentrations in assets, customers, or suppliers)
   
   o Risk of illiquidity
   
   o Contingent gains and losses related to the business's rights and obligations, including legal proceedings

(B) Management's Plans, Including Critical Success Factors

1. The identity of management's activities and plans to meet the broad objectives and business strategy identified in V(A) that management believes will significantly impact future cash flows

2. The identity and importance of factors or conditions that management believes must be present to meet the broad objectives and business strategy identified in V(A), on the following bases:
   
   a. Factors and conditions that must occur within the business.
   
   b. Factors or conditions that must occur in the external environment.

(C) Comparison of Actual Business Performance to Previously Disclosed Opportunities, Risks, and Management's Plans

For the following categories of leading indicators, the identity of major differences between previously reported information and actual results and the reasons for those differences:

1. Opportunities and risks, including those from key trends.

2. Management's plans, including critical success factors.

IV. Information About Management and Shareholders

(A) Directors, Management, Compensation, Major Shareholders, and Transactions and Relationships Among Related Parties
1. Identity and background of directors and executive management. Background information about executive management is not required if the executive has been in the same position with the company for the past five years. The identity of any criminal convictions related to directors and executive management is required.

2. The types and amount of director and executive management compensation (broadly defined) and the methods or formulas used in computing that compensation. The board's policies for executive compensation and the relationship of company performance to executive compensation.

3. Security Ownership
   a. The identity of each major owner of the company's stock, and the number of shares that each owns.
   b. The number of shares owned by the directors as a group, management as a group, and employees as a group.
   c. The nature of existing arrangements that could result in a change in control of the company.

4. Transactions and relationships among major shareholders, directors, management, suppliers, customers, competitors, and the company.

5. Nature of disagreements with directors, independent auditors, bankers, and lead counsel who are no longer associated with the company.

6. Information about compensation committee interlocks and insider participation in compensation decisions.

V. Background About the Company

As noted previously, non-financial information is important to understanding a company, its financial statements, the linkage between events and the financial impact on the company of those events, and for predicting the company's future. In contrast to disclosing quantitative measurements that management believes are significant and meaningful to its business, the following disclosures of non-financial information generally would be of a qualitative nature, although companies should supplement qualitative disclosures with quantitative measurements where practical and meaningful, assuming those measurements are sufficiently reliable for external presentation. To the extent non-financial information is not known to the company or is considered insignificant to understanding its operations or to an understanding of the company and its financial statements, disclosure is not required.

(A) Broad Objectives and Strategies

1. Broad Objectives
a. Management's broad objectives for the business, including those objectives that include quantified measures.

2. Strategy

a. Management's principal strategies to achieve the broad objectives identified in V(A)1.

b. Discussion of the consistency or inconsistency of the strategy with key trends affecting the business identified in II(A)2.

(B) Scope and Description of Business and Properties

The following items, which may replace much of what is currently reported by U.S. public companies in filings with the SEC, while not all-inclusive, should be considered for disclosure:

1. Management's description of the industry or industries in which its business or businesses participate.

2. Description of the general development of the business. For example, the year organized, if within the past five years; the form of organization; the identity of major events within the past five years, such as bankruptcy, merger, dispositions of assets, and changes in mode of conducting the business.

3. Description of principal products produced and services rendered.

4. Description of principal markets and market segments (based on demographic, geographic, use of product, or other basis) served by the segment's products and services.

5. Description of processes used to make and render principal products and services.

6. Description of key inputs to the processes, including materials, human resources, and capital additions.

7. Description of distribution and delivery methods for principal products and services.

8. Description of any seasonality and cyclicality (resulting from general economic cycles) related to the segment's products or services.

9. The types of existing and proposed laws and regulations that management believes have or could have a significant impact on the business.

10. Description and duration of important patents, trademarks, licenses, franchises, and concessions that offer the business a competitive advantage.

11. Description of types (not measures) of macroeconomic activity, such as housing starts or defense spending, that management
believes are closely correlated with the business's revenues or expenses. Users can, and should, independently obtain measurement information pertaining to macroeconomic activity from sources outside the company.

12. Description of major contractual relationships between the business and its customers and suppliers.

13. The location, nature, productive capacity, and extent of utilization of the company's principle plants and other important physical properties.

**(C) Impact of Industry Structure on the Company**

1. Management's information about technological and regulatory changes that may affect the business's market through introductions by others of products or services that are superior to those offered by the business.

2. The Bargaining Power of Resource Providers
   a. Identity of the general types of major resources and related suppliers.
   b. For each general type of resource, the availability of supply and the relative bargaining power of the suppliers to the business. The discussion should highlight cases in which the business must rely on only one or a few suppliers for a general type of resource, the loss of any one of which would adversely affect the business.
   c. If possible, measures of relative bargaining power, such as the number of resource providers available to the business offering a general type of resource and the magnitude of recent price increases or decreases for a general type of resource.

3. The Bargaining Power of Customers
   a. The extent to which the business is dispersed among its customers. The discussion should include measurements of that dispersion. For example, companies might present a table indicating the number of customers, based on descending order from largest to smallest, generating 10 percent of revenues, 25 percent of revenues, and in total.
   b. The names of any dominant customers.
   c. If possible, measures of the relative bargaining power of customers. Those measures could include, for example, the magnitude of recent price increases or decreases for the business's major products and the number of customers gained and lost for a recent period.

4. The Intensity of Competition in the Industry
a. The dispersion of competitors, such as the number of competitors and the names of major competitors.

b. Measures of the intensity of rivalry, if possible to develop. Examples of those measures include frequency of price changes in response to competitor price changes; number of customers who switch from competitors to the business and vice-versa; capacity utilization; and average number of companies bidding on major contracts.
IV — Background About The Committee And Its Work

Events that Led to the Committee's Formation

The Committee was formed in April 1991 by the AICPA Board of Directors. A number of events led to that action. They go back at least as far as 1988 when the profession was subject to significant criticism by the accounting profession itself, by academics, and by Congress and regulatory bodies. The AICPA Strategic Planning Committee then urged the AICPA to play a more effective role in the accounting standard-setting arena and to develop an aggressive program designed to enhance the relevance, reliability, and cost-effectiveness of business reporting. The AICPA Future Issues Committee reported the same year that business reports are losing their significance because they are not future oriented and do not provide value-based information.

In the spring of 1990, Thomas W. Rimerman, then vice-chair of the AICPA Board of Directors, published an article in the April 1990 Journal of Accountancy on “The Changing Significance of Financial Statements.” The article called for the appointment of a new blue-ribbon commission to study the relevance of reporting. Mr. Rimerman’s article was followed in the fall of 1990 by the Wharton Symposium on Financial Reporting and Standard Setting, which also called for change: “Continuing on the present course, we believe, will lead to the growing irrelevance of conventional financial reporting in the new age of information.” The symposium concluded that, while the current accounting model should not be scrapped, it should be reengineered to provide more relevant information to users of financial statements. It also concluded that this reengineering would require research as to what users require followed by different levels of information to meet those needs.

Other commentators in the United States were raising similar issues:

- The American Accounting Association Committee on Accounting and Auditing Measurement, 1989-1990, concluded that “...the most general criticism to be leveled at financial statements in their present form is that they are seriously incomplete.”
- The Financial Executive Research Foundation agreed in 1991 to a research proposal to study economic reality in financial reporting, including economic valuation concepts, innovative reporting practices, and performance measurements and reporting.
- A.A. Sommer, Jr., chair of the Public Oversight Board of the SEC Practice Section of the AICPA Division for CPA Firms, said that “the time may be ripe for ...a National Commission on Auditing and Accounting...”
- Walter P. Schuetze, a past chair of AcSEC and now chief accountant of the SEC, said that “We need an... inquiry into the met and unmet needs of users of financial statements.”

Meanwhile, similar events were occurring in other countries. U.K. accountancy bodies issued several documents challenging current business reporting:

- Making Corporate Reports Valuable (1988): “The present model for corporate reporting is not satisfactory... Present-day financial statement packages seldom give any indication of the overall objectives of the entity; and even crucial information about its management and ownership is provided only on a limited scale.”
- Financial Reporting, The Way Forward (1990): “What is principally wrong with present financial statements is that they do not reflect the economic reality of a company’s progress and position... Present day financial statements are deficient in that they concentrate on... past events rather than the future.”
- The Future Shape of Financial Reports (1991): “There is increasing support for the view that the existing financial reporting package is not adequate to meet the needs of users. The balance sheet and profit and loss account have evolved from the limited requirements of reporting in the developing industrial economy of the nineteenth century, and extensive tinkering has not been sufficient to bring them in line with the requirements of the late twentieth century market economy, ... The contents of financial reports should be user driven...”

The Canadian Institute of Chartered Accountants issued the Report of the Commission to Study the Public's
Expectations of Audits (1988): "The CICA should initiate . . . a study of risks and uncertainties leading to conclusions as to how they may best be disclosed in financial statements or elsewhere [in the business report]."

The Committee’s Charge

The AICPA Board of Directors charged the Committee to recommend (1) the nature and extent of information that should be made available to others by management and (2) the extent to which auditors should report on the various elements of that information. It also required the Committee in developing its recommendations to determine the understanding of the information currently provided by financial statements and the perception of the assurances provided by auditors and to evaluate the full range of information and assurances that should be made available. The charge required the Committee to consider whether its recommendations would apply to all entities or only some and that the Committee also consider whether there is a need for any structural changes in the standard-setting process to increase the likelihood that its recommendations would be implemented.

The Committee's charge was broad in scope. Due to time and resource constraints, it was necessary to limit the Committee's work to the most critical concerns that led to its formation. As a result, the Committee decided to focus on for-profit entities and to exclude not-for-profit entities and governmental organizations.

Similarly, the Committee decided to focus on investors, creditors, and their advisors that use information for decision making but cannot compel information from the preparer. While the Committee was aware there are many other users of externally reported information, including employees, government agencies, and others, it decided the primary users — and those associated with the concerns about business reporting — were investors and creditors.

Committee Members and Staff

The following persons were members of the Committee:

Edmund L. Jenkins, partner, Arthur Andersen, chair

Michael H. Sutton, partner, Deloitte & Touche, vice-chair

Lonnie A. Arnett, vice-president and controller, Bethlehem Steel Corporation

Raymond J. Bromark, partner, Price Waterhouse

Edmund Coulson, partner, Ernst & Young

Robert K. Elliott, partner, KPMG Peat Marwick

Larry G. Grinstead, partner, Baird Kurtz & Dobson

William W. Holder, Ernst & Young Professor of Accounting, University of Southern California

Robert L. Israeloff, partner, Israeloff, Trattner and Co.

Gaylen N. Larson, group vice-president and chief accounting officer, retired, Household International

Joseph D. Lhotka, partner, Clifton, Gundersen & Co.

James C. Meehan, partner, retired, Coopers & Lybrand (member of the Committee 1991-1992)
Members were chosen to represent a broad cross section of the AICPA membership. In addition to those from large accounting firms, representatives of medium-sized and smaller accounting firms, the business community, and academia were included in the Committee's makeup. One group missing was users. However, a major focus of the Committee's work involved direct contact with a large number of users, so their input was readily available to the Committee.

The Committee also benefited from four observers who participated in meetings and otherwise provided guidance and information. They were:

John W. Albert, SEC staff
Joseph V. Anania, member, FASB
Robert J. Swieringa, member, FASB
Robert G. Weiss, Institute of Management Accountants

The staff work of the Committee was performed by a large group of individuals provided by Committee members' firms, the AICPA, and the FASB. The Committee could not have completed its work without the exceptional efforts of the staff, the principal members of which were:

Karen F. Berk, FASB
Val R. Bitton, Deloitte & Touche
Jeannot Blanchet, FASB
Mark D. Carleton, KPMG Peat Marwick
David P. Cook, Ernst & Young
Janet L. Danola, FASB
James V. DiVizio, Ernst & Young
Christine S.R. Drummond, Price Waterhouse
Naomi Erickson, Deloitte & Touche
Bruce R. Herard, Deloitte & Touche
Richard K. Herlin, Deloitte & Touche
Peter D. Jacobson, KPMG Peat Marwick

David M. Lukach, Coopers & Lybrand
Reed S. Mittelstaedt, Price Waterhouse
Timothy S. Nelson, Arthur Andersen
E. Mark Rajkowski, Price Waterhouse
Paul H. Rosenfield, AICPA director of technical standards and services
Ferdinand Schmitz, IV, Ernst & Young
Carol A. Selhorn, KPMG Peat Marwick
E. Raymond Simpson, FASB
Sally P. Smith, KPMG Peat Marwick
Reed K. Storey, FASB
Robert M. Vreeland, Coopers & Lybrand
The Committee organized its work to take in a broad range of input into the decision making process. It also operated as a working committee rather than relying primarily on staff work. As a result, the Committee not only met frequently as a committee but also participated in subcommittee meetings, formed a special task force, commissioned research, and directed the work of its staff. More specifically, the Committee operated with the following subcommittees and task force:

- **Current Model Enhancement Subcommittee** was charged with considering changes to financial reporting on the assumption that the present model will be retained in preparing general-purpose financial statements. It studied areas frequently cited by users as currently deficient, including disclosures about measurement uncertainties, opportunities, risks, and liquidity; disaggregated and segment information; and off-balance-sheet items.

- **New Model Subcommittee** was charged with considering whether there is a new business communication model that should modify or replace the model currently in use. It analyzed alternative financial reporting models, including various fair value models, and the need for information on changes in general purchasing power and evaluated forward-looking and prospective information. This subcommittee supervised the work of the Breakthrough Task Force.

- **Non-Financial Business Reporting Subcommittee** was charged with considering the extent to which business reports should include non-financial information. That includes all the information about the business of the reporting entity other than financial measurements of the entity's past, present, and future resources and obligations and the results of its operations or cash flows. The subcommittee considered information about economic, social, and technological trends; industry structure and outlook; and the company's mission and objectives and its success in meeting those objectives as indicated by various performance measures.

- **Users' Needs Subcommittee** was charged with providing information for use by the other subcommittees about the categories of users of financial information and the nature, timing, and reliability of information that users need. It directed the research on users' needs for information.

- **Integration Subcommittee** was charged with taking the conclusions of the Current Model Enhancement Subcommittee, the New Model Subcommittee, and the Non-Financial Business Reporting Subcommittee and preparing, from the elements of those conclusions, a comprehensive model of business reporting for use by the Committee in preparing its final recommendations. It was also charged with preparing a comprehensive illustrative business report based on the comprehensive model.

- **Auditor Association and Differential Reporting Subcommittee** was charged with considering the extent of auditor association with information traditionally presented in financial statements; whether to continue with standardized reporting; what kinds of association auditors should have with information in business reporting outside financial statements; and whether auditors should include commentary such as that on the opportunities, risks, and uncertainties associated with the reporting entity and the financial presentation.

- **Breakthrough Task Force** was charged with assessing who the users of business information will be in the year 2005; the kinds of decisions such users are likely to be making then; and the kinds of business information that will be presented to aid them in making those decisions. The task force contemplated the forces that will shape the global business environment in the longer term and the implications of those forces on the needs for information. The task force studied what entities will be called on to provide business information; to whom the information should be directed; and what kinds of information will be required to serve the decisions made, including the nature, frequency, channels, and extent of communication of such information.

To provide a broad perspective, the task force included experts from various disciplines — including business strategy, management, economics, finance, accounting, information technology — and a futurist. The members of the task force who were not members of the Committee were:
Ray Ball, *University of Rochester*

Victor L. Bernard, *University of Michigan*

Arnold Brown, *Weiner Edrich Brown*

William H. Davidson, *University of Southern California*

Esther Dyson, *Edventure Holdings*

Robert C. Merton, *Harvard University*

Robert H. Northcutt, *FASB*

C.K. Prahalad, *University of Michigan*

- **Structure and Process Subcommittee** was charged with assessing the environment for business reporting and changes in the environment necessary to facilitate improvement in business reporting.

The following persons participated in research projects for the Committee:

Louis Harris, chairman, LH Research, Inc.
— Telephone survey of 1,200 users of business reports, which gathered data used as a check against information previously obtained from and about users of business reporting.

Robert J. Bricker, professor, Case Western Reserve University

Gary J. Previts, *professor, Case Western Reserve University*

Thomas R. Robinson, *University of Miami*

Stephen J. Young, *Case Western Reserve University*
— Research that inferred information needs from data in analysts’ reports on companies and industries.

Paul M. Healy, *professor, Massachusetts Institute of Technology*

Krishna G. Palepu, *professor, Harvard University*
— Research that inferred information needs from data companies voluntarily provide to investors.

Paul A. Pacter, *professor, University of Connecticut*
— Research sponsored by the FASB on the information needs for disaggregated information.

In addition, as discussed in chapter 2, the Committee formed two discussion groups that included various types of investors and creditors.

**The Committee’s Process of Reaching Consensus on Conclusions and Recommendations**

Reaching consensus on conclusions and recommendations began with the work of subcommittees. They determined the issues to consider in consultation with the Committee. They prepared papers on the issues, considered the evidence presented, and debated the issues based on that input. After reaching tentative conclusions, each subcommittee presented them and the evidence to the Committee. The Committee then reviewed and discussed in detail the work of the subcommittees in reaching tentative conclusions. Once the Committee reached its own tentative conclusions, it continually reviewed them based on new evidence or new reasoning and modified them as the evidence or reasoning required.
The Committee's process of developing recommendations included three key procedures: identifying the benefits and costs of decision-useful information, identifying types of information that could provide significant benefits to business report users, and developing criteria that limit costs in cases in which costs could be significant. Those procedures are discussed in chapter 4.

The Committee's goal was to develop an integrated package of recommendations to improve business reporting that the entire Committee would be able to support. A tentative conclusion was incorporated into the package of recommendations if a substantial majority of the Committee members agreed to support it. Nevertheless, the Committee's process of reaching consensus emphasized the package rather than individual recommendations. The Committee goal of reaching consensus was consistent with the Committee's role as a study group developing recommendations, in contrast to the approach used by standard setters, such as the FASB.
V — Overview of The Committee’s Database

The Committee included materials from its study in a database it is making available to assist others in their research on the information needs of users. The database, *Database of Materials and Users’ Needs for Information*, is divided into seven sections as listed and described below.

I. The Committee’s Analysis of Information Needs of Investors and Creditors

This document summarizes the Committee’s analysis of users’ needs for information based on the information included in section II of the database. The introductory material discusses the objectives, scope, basis for analysis, guiding principles, and organization of the analysis.

II. Material Extracted from Documents Authored by Users or Based on Research Directly with Users About Their Needs for Information

This section presents what investors and creditors have indicated about their needs for information in a manner that best facilitates analysis. Thus, the materials are organized into categories and subcategories as listed in the introduction to the section, which also discusses the objective, organization, contents, and format of the materials.

The materials are extracted from direct documents, authored by users, or are based on research directly with users. They include extracts from the direct documents listed at the front of the database.

In addition to extracts from previously published documents, the materials include extracts from new research sponsored by the Committee. New research resulted from the Committee’s formal discussions with investors and creditors. The materials include the transcripts from those discussions, divided by topic. The second type of new research infers users’ information needs from the contents of analysts’ reports. Extracts from that research also are distributed across various topics within the materials. The study of analysts’ reports is included in section III.

III. Report on the Content Analysis of Sell-Side Financial Analysts’ Reports

This research report infers users’ information needs from the reports of sell-side analysts. Excerpts from it also are included in section II.

IV. Report on the Content Analysis of Information Voluntarily Supplied by Companies to Users

The Committee also sponsored this research, which was not completed in time to be included in section II. It is based on documents certain public companies, which agreed to participate in the study, provided to users.

V. Survey of Investors and Creditors

The Committee sponsored a survey, conducted by LH Research, Inc. and directed by Louis Harris, to confirm or refute with a large number of user sits conclusions about users’ needs as discussed in its analysis (section I).

The survey is in three parts. The first is the Committee’s analysis of the survey, comparing and contrasting the results of the survey with the conclusions the Committee reached in its earlier analysis (section I). The second presents the results of the survey, with commentary by Louis Harris. The third is the survey instrument.

VI. Report of the Committee’s Breakthrough Task Force
The Committee sponsored a task force of experts in various disciplines to help develop a longer term perspective. The Task Force considered the directions in which business information is likely to evolve as a result of changing social, political, economic, technological, regulatory, and other forces. Section VI includes the task force's report.

VII. Bibliography of Source Documents Referred to by the Committee

The bibliography lists many of the published documents the Committee considered in developing recommendations, including documents about users' needs for information as well as other matters.

The Database of Materials on User’s Needs for Information, is available on the Internet at: http://accounting.rutgers.edu/raw/aicpa/dbase/d_index.htm