

Constituents' Commentary

The Critical Nature of Neutral Financial Reporting

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The purpose of financial reporting is to tell a company's economic story, its financial position and the results of its operations, as completely, clearly and faithfully as possible.

In other words, its job is to tell the story as it is. The role of fiction is to tell the story as it isn't now, and perhaps never was or ever can be, but rather as the author would *like* the story to be told. A writer of fiction may well have some other objective than merely spinning a good yarn, including possibly a desire to influence some outcome.

To the extent that financial information is manipulated to achieve a particular outcome rather than to faithfully report economic events and activity, the resulting information is biased. *Neutral* information is free from bias. For information to have value to investors and other users, it is critical that it be neutral.

Investors depend on financial information for their investment decision making. For example, investors routinely use financial disclosures in evaluating a company's growth prospects, its riskiness and the long-term success of the company's business model. These analyses also provide the inputs investors need to price individual securities and to make portfolio decisions. Taken altogether, the quality of investors' pricing and capital allocation decisions affects the relative efficiency and effectiveness of financial markets.

Simply put, when financial disclosures do not tell the economic story as it is, the prices of securities, and even the amounts of capital allocated to companies, are not likely to reflect the company's actual economic position. For example, if a company suffering large losses is made to appear profitable by the selective omission of expenses from the company's income statement, then investors who are not aware of the omissions will price the security more favorably than is warranted. They also may allocate larger amounts of their limited capital to the company than they otherwise would, based upon more complete information.

Unfortunately, in the last several years, investors have lost tens of billions of dollars—their retirement savings and other productive capital—for precisely that reason. Companies with, at best, marginal profitability understated expenses in the income statement. When these misstatements became known, the companies collapsed, destroying not only their investors' capital but also the trust and confidence of investors worldwide. That is, the reporting problems of some companies affected not only those companies, but the prices investors were willing to pay for others as well.

The setting of financial reporting standards has always been contentious, with various constituents desiring to influence standards in ways that best reflect their own interests. Such discussion and debate is a healthy and essential part of the standard-setting process and serves both to strengthen the quality of the resulting standards and to speed the evolution to global best practices. However, when such debate and deliberation is interdicted or cut short, and the course of standard-setting is subverted to achieve an objective other than the faithful representation of economic events, then not only investors' capital but the viability of financial markets is threatened.

As we have said, investors must have not only high-quality information to make decisions and risk their scarce funds, but also confidence in the reliability and neutrality of that information. When it becomes apparent that the financial reporting system no longer can be relied upon to produce such information, investors realize that they have assumed a new and potentially catastrophic risk: financial reporting risk. To be convinced to bear such a risk, investors will require a much higher future return, and they will achieve this by reducing the price they are willing to pay for all securities. Thus, the reporting deficiencies of some companies can become a contagion affecting all.

We have seen this reality at work. When it became apparent to investors over the last two years that at least some large companies were misstating their results by understating expenses, overstating income and understating their obligations, they were quick to express their displeasure by withdrawing capital from some companies, and reducing prices for many others. Consequently, not only investors but issuers as well, both healthy and unhealthy, suffered alike.

As James J. Leisenring, former Vice Chairman of the FASB and currently a member of the IASB, wrote in an article titled, "The Meaning of Neutral Financial reporting," published by the FASB in the September 30, 1999 issue of *The FASB Report* (formerly *Status Report*):

The dissemination of biased and thus potentially misleading information is bad for all interests in market-driven economies. Even a perception that the information has been manipulated may have significant adverse consequences for the cost and availability of capital.

In the face of the severe loss of trust and confidence, both Congress and the various regulatory bodies acted swiftly to make

the changes they deemed necessary to repair the damage and help reverse the decline.

Unfortunately, however, the problems are not yet solved. Even given the recent history in the financial markets, we are seeing renewed assaults on the reliability and neutrality of financial reporting. Having failed to persuade standard setters to adopt their views on particular reporting issues, including stock options and pension reporting, some special interests have turned to other means to try to alter the outcome of the standard-setting process.

The argument they put forward is that it is necessary to misstate the results of a company's operations and financial position in order to achieve a particular desired outcome—for example, higher reported income as a result of ignoring expenses, or a smaller cash contribution to the company's pension plan. They argue that neutral, reliable financial reporting should be set aside so that the objectives of some individual companies and their employees can be achieved.

Will the resulting misstatements be cost-free? Certainly not. The gains to a few would come at a direct cost to others who receive none of the benefits. Those who have suffered huge losses before from deliberate misstatements, investors, employees, retirees and, on occasion, even the taxpayers, may do so yet again. A great deal is at stake here. We believe that these continued assaults on the integrity of our financial information ultimately could be destructive to the financial markets upon which we all depend.

At present, the U.S. financial markets are still the strongest in the world. However, other markets are developing rapidly. A global competition is underway to determine which will be the most efficient and effective and thus attract the most capital. This is good for investors. But for U.S. markets to be able to compete in this game, investors must have confidence that the financial information they receive can be trusted to tell the company's story as it is, not as a few might want it to be.

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