# Commentary: Is the Reporting Model Broken?

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*There have been frequent claims in recent decades that the reporting model is broken and needs to be replaced by a new one. Is it really broken? If so, why? And what should be done about it? These issues were discussed by a team of distinguished academics and practitioners in a panel session at the American Accounting Association meeting in San Francisco in August 2010. This commentary summarises the discussion. While panellists agreed that the reporting model is broken, they identified different problems with it. Key concerns included length, complexity, the dominance of a compliance mindset, reporting on intangibles, an excessive focus on financial reporting, and the need for an integrated approach to reporting. Concern was also expressed about the approach of financial reporting standard setters, including to the role of fair value, and their assumption that it is possible to find 'God's method of accounting'.*

The panel at the American Accounting Association meeting comprised:

- Robert Hodgkinson (moderator), Executive Director, Technical, ICAEW
- Bob Laux, Senior Director of Financial Accounting and Reporting, Microsoft Corporation
- David Phillips, Senior Corporate Reporting Partner, PricewaterhouseCoopers
- Shyam Sunder, Professor of Accounting, Economics and Finance, Yale School of Management
- Ross Watts, Professor of Accounting, MIT Sloan School of Management.

David Phillips argued that the reporting model is broken. It focuses too much on financial information, which is important, but should not dominate reporting in the way it does. For example, the credit crunch has highlighted shortcomings around the reporting of risk and the dynamic of the business model. Furthermore, the evolutionary nature of reporting has resulted in new bits – such as sustainability reporting – being bolted on to the basic model without revisiting how reporting works as a whole. As a result, reports have become too long, complex and impenetrable – it's very difficult to see the wood for the trees. Companies should be able to say everything important, even for the professional investor, in 50 pages.

The behavioural aspects are significant. A compliance mindset dominates – it's all about box ticking, not communication. External reporting has become remote from how the company is managed internally, so few directors are interested in the reports they are responsible for, and few understand the technical complexity of the financial information they contain. Nor do they give investors the information they really need.

The International Integrated Reporting Committee has just been established to provide a reporting framework that will integrate management, discussion and analysis (MD&A) with financial reporting, governance and remuneration, environmental and social reporting. This will focus on information of interest to investors and try to bring reporting closer to the information used by managers to run the business.

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Bob Laux agreed that the model is broken. There is a shocking diversity between the information that executives discuss with Wall Street and the information in financial reporting (including MD&A). For Microsoft, the intangibles that drive most of its value do not even appear on the balance sheet; there is a need to find some way of reporting them, rather than just ignoring them. This does not necessarily mean valuing them in the accounts.

There should be an integrated approach to reporting, with a focus on strategy, its execution, and relevant key performance indicators (KPIs). Environmental, social and corporate governance reporting would be part of this, but so too reporting on intellectual capital/intangible assets.

One worry, though, is that this kind of reporting could be turned into a public relations document rather than used to give an impartial picture. Another worry: will auditors be able to cope? This sort of information goes beyond what they are used to in their traditional attest function.

Shyam Sunder also agreed that the model is broken. The Standards Boards (the International Accounting Standards Board, IASB, and Financial Accounting Standards Board or FASB) misinterpret the Hicksian approach to income measurement. The significant instability in financial reporting provides evidence that the model is broken – tens or hundred of billions appear and disappear within days of each other. Standards are already thousands of pages long and growing rapidly. Standard setters spend five years developing a new standard, and someone at an investment bank finds a way around it in five minutes. Financial engineers serve the needs of their clients by, for example, keeping liabilities off the balance sheet and having revenue recognised when they want it to be. There is an assumption that there exists some ideal 'set' of financial reporting standards, and that a competent, public-minded standard-setting body will find this 'God's method of accounting', if only they had adequate time and resources. Such a set of standards may not exist, and we have unreal expectations of standard setters.

The solution is to depend less on written standards, which do not really protect companies and accountants against litigation anyway, and to rely more on accountants' professional judgement based on social norms of accounting. These social norms would reflect – and used to reflect – what is genuinely 'generally accepted' rather than what is imposed by standard setters.

Ross Watts agreed that the financial reporting model is broken. Financial statements are meant to be inputs to the valuation process, not to provide a valuation. But fair value is a valuation, not an input to valuation.

However, there seems to have been a turning point in the movement towards fair value. Until December 2008, the FASB's approach to fair value in revenue recognition involved valuing the firm. But the financial crisis made people realise that this was not going to work. FASB's December 2008 proposal – *Preliminary Views on Revenue Recognition in Contracts with Customers* – marks a change of direction. The new direction is back towards real revenue recognition that cannot be manipulated as easily by management.

We got to where we are now because people thought that accounting should value the firm, but that's not what it's about. We need good, traditional accounting if we're going to avoid a repetition of the crisis we've just had. In the run-up to the crisis, banks were cherry-picking favourable fair values for securities, so they were overstated in the accounts.

The panel session was attended by about 80 conference delegates, and there was a lively Q&A session with questions and comments from the audience. Responses to some of these are included in the summary above. Comments and questions included:

- was the financial reporting model ever not broken?
- intangibles represent 60% or more of the value of US corporations – this is an issue we must not duck
- maybe the problem is that we can't predict failure?
- financial reporting standards are designed to be manipulated.

The session was sponsored by the AAA Financial Accounting and Reporting Section and organised by the Institute of Chartered Accountants in England and Wales (ICAEW).

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