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Corporate Accounting Practices

Testimony before the House Financial Services Committee; Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises

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I am pleased to testify before you today on issues relating to corporate disclosure that I believe ultimately are of greater importance to investors and to financial policy makers than the immediate issues that have arisen out of the failure of Enron. I know this is a bold statement, but I hope that before this hearing is over the members of the Committee will believe it to be accurate. Indeed, the fact that the Committee has called for these hearings on the future of the current corporate reporting model in today's business and investment culture provides strong evidence of why investors and policy makers should be interested in disclosure beyond the immediate concerns raised by Enron.

I was asked to testify today because of research I conducted on these subjects in conjunction with Peter Wallison of the American Enterprise Institute, reflected in *The GAAP Gap: Corporate Disclosure in the Age of the Internet*, published by the AEI-Brookings Joint Center for Regulatory Studies in 2000. I believe the Committee has copies of this book, but one can also be easily downloaded from the Joint Center's website (www.aei.brookings.org).

I will now highlight several important conclusions from this study and the policy implications I believe flow from them. I will not address, however, issues relating to auditing and enforcement—topics that this Committee and indeed the full House have already addressed in legislation authorizing the creation of a new Public Regulatory Board to oversee the auditing profession.

Summary of Findings

Central to functioning of all capital markets is the continuing flow of accurate, relevant and timely information. Enron reminded a number of well known companies of this simple truth when their stock prices plummeted because commentators and investors feared that they were not disclosing sufficient information to enable the market to understand their businesses and the risks (and opportunities) they presented.

Information is critical because equity markets price the future. The price of a share of a stock at any point in time reflects the collective judgment of investors who have most recently traded it about the cash flows the company can be expected to generate in the future, and how uncertain or risky those cash flows may be. Other things being equal, the higher the projected cash flows and the less risky they are deemed to be, the higher the price of the stock relative to its current or projected earnings.

The financial information that companies now routinely report to investors—balance sheets and income statements prepared according to the Generally Accepted Accounting Principles (GAAP) set by the Financial Accounting Standards Board (FASB)—is important, but also of increasingly limited value for understanding the future prospects of many companies. This is so for several reasons:

First, recent financial reports inherently are backward looking, especially so because, for the most part, assets and liabilities are recorded at historical costs, not current market values. To be sure, many analysts and investors use most recently disclosed earnings reports in particular to extrapolate into the future. But as the recent market turmoil has demonstrated, this can be very dangerous since the future for many firms may not look at all like the past. In any event, we are not the first to point to the backward looking nature of financial statements: as early as 1991, more than a decade ago, FASB issued a report—now known as the Jenkins report—making the same observation. Unfortunately, not much has happened since in the profession or the SEC, for that matter, to ensure that investors are provided with more useful, forward-looking information. To the contrary, "the future" has become what the analyst community says it is, with firms under increasing pressure to hit or exceed analysts' earnings projections. For many, this pressure leads to the widely derided practice of "earnings management," or the manipulation of reported revenues and expenses in ways that generate reported earnings that do not disappoint market—or more accurately, analysts'—expectations.

Second, much of the value the market assigns to many companies cannot even be found on their balance sheets (or income statements). This is because that value is *intangible* and cannot be easily bought and sold in the marketplace independent of the company itself. Here I refer not just to intellectual property—patents, copyrights, trademarks, and trade secrets—but also the value of a company's workforce, its customer base, its name brand, and all other intangibles that contribute to its ability to generate earnings. Contrast all of these items with fixed assets like plant and equipment that can be sold and are the staples of the asset side of balance sheets for most companies.

Intangibles are important not only for so-called high-tech companies, but also for many "old economy" enterprises that may have unique production processes, highly trained work forces and stable customer bases. How do we know that intangibles are so important? Because they market tells us so. As Baruch Lev reports in his book *Intangibles*, published recently by Brookings, at the end of the 1990s the market value of the stocks in the S&P exceeded their book values by 6 times, up from 3 times earlier in the decade. Even though stock prices have receded somewhat since, they still generally remain far above book values—striking proof that we are in a new intangibles-based economy.[1]

Third, non-financial information relevant to pricing the future that may never directly show up in any financial report is constantly being generated—in any event much more frequently than quarterly and certainly annually. The disclosure of this information is important, and indeed critical, to investors. A few examples: the gain or loss of new customers, insider sales or purchases of the company's stock, changes in management, new patents, and so forth. To its credit, SEC has proposed that more such information should be disclosed in so-called 8-K filings by companies, and more rapidly (within 2 days rather than 5-15) than ever before. In addition, companies increasingly are webcasting their analysts conferences on the Internet so that anyone can get the same information, at the same time, as the analysts (a situation required under the SEC's controversial, but I believe commendable, Regulation FD).

Fourth, the development of new computer-based technologies, especially the Internet, may soon make it possible for investors on their own—or through independent advisers—to manipulate company-specific information so that they need not rely on the GAAP-based financial statements that companies now produce. Specifically, I refer here to the development of a new computer language, XBRL, based on another more general language XML, that allows firms to place "tags" or identifiers on all kinds of financial

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[1] There is a growing literature in economics on the sources of this intangible value, with increasing evidence that one driving factor is information technology and the ability IT gives to firms to reorganize their operations in more efficient ways. This argument is fleshed out in a forthcoming paper in the *Brookings Papers on Economic Activity* by several leading researchers in this field, Erik Brynjolfsson of MIT, Lorin Hitt of the University of Pennsylvania and Shinkyu Yang of New York University.

and non-information in their possession.[2] With these tags, users can then manipulate and rearrange firm-provided data in any manner that they see fit. This is simply not possible with the current HTML-based text that companies now release on the Internet, which is fixed and cannot be rearranged. I will have more to say about XBRL shortly.

In short, by their very nature, GAAP-based financial statements are inherently limited in the kinds of information they provide to investors and on what schedule. The critical question for firms, their accountants, the investing public, and policy makers like you, is what steps should be taken now and in the future to provide the markets with more useful, relevant information that improves the ability of all market participants to better judge the future prospects of individual firms. The more effective that process is, the more efficient our capital markets will be in allocating funds to those companies that most deserve it, while reducing the costs of raising capital for all those firms that need it.

Implications

These conclusions have several policy implications.

First, what should be done about the growing importance of intangibles? One natural response could be to require firms to put values on their various intangible assets, and perhaps even more ambitiously, estimate how those values might increase or deteriorate over time, with the changes reflected in income statements. This is an understandable, but ultimately impractical, reaction however. Precisely because there are few, if any, organized markets for intangible assets, there are no objective ways for firms and—more importantly in light of the recent events surrounding Enron—their auditors to verify most, if not all, of these values (unless the assets are purchased, or valued at cost).

To be sure, some accounting adjustments might improve matters. In particular, accounting standards-setters should be more flexible in allowing companies to capitalize certain investments that lead to the creation of intangible value. One of my favorite examples from our book is when AOL was incorrectly, in our view, required by the SEC to expense its marketing costs—largely the distribution of free diskettes. In retrospect, the handing out of free disks was a critical investment by the company in building up its customer base, which today ranks among the most important assets of the company. AOL

[2] XBRL is being pursued jointly by the accounting profession, largely through the AICPA, and a growing number of publicly held firms around the world.

should have been allowed to capitalize this investment, not write it off as the disks were handed out, thus depressing earnings in each of those years.

Improvements in financial reporting can only go so far, however, in doing a better job of capturing intangible value. Ultimately, a more productive course is for firms to disclose more *non*-financial information that may give rise to intangible value. Here I refer to measures of consumer or worker satisfaction, product or service quality, successful innovation, education and experience of the workforce and management, and a variety of other non-financial indicators that individually or collectively, can shed far more light for investors on the future ability of firms to generate earnings or cash flow than GAAP-based financial reports. Various experts, including individuals who are testifying before you today, have worked to develop lists of these non-financial indicators.[3] In *The GAAP Gap* we urge the SEC to use its powers of persuasion in this area, perhaps by beginning to convene working groups of experts from different industries, to encourage firms to make more of these disclosures, and to do so consistently and repeatedly.

A second policy challenge is how best to harness the power of technology—computers and the Internet—to facilitate more complete and more rapid corporate disclosure. Once the XBRL-based tags are fully developed and implemented by companies, a wide range of users—not just sophisticated ones like financial analysts -- will be able to take very detailed data from companies and reconfigure it in multiple ways, using widely available spreadsheet programs. But here, too, there is a role for the SEC: to encourage this project and do what it can to publicize its importance and encourage companies to participate in the process of developing tags for information that may be industry-specific. The Commission may also want to consider ways in which it could encourage companies to use the tags at the earliest possible date. One possibility: require EDGAR submissions to be in XBRL by a specific date.

A related project is for the SEC to encourage more frequent reporting, but not just the events required as part of the 8-K filings. With the Internet, many companies now or may soon have the ability to make available to the public their *financial reports* much

[3] See, e.g. Robert K. Elliott, "The Third Wave Breaks on the Shores of Accounting, " *Accounting Horizons* 6(2) (1992), pp. 61-85; *Improved Business Reporting – A Customer Focus*, American Institute of Certified Public Accountants, February 21, 2000 (www.aicpa,org/members/div/accstd/ibr/appiv.htm); *Value*

more frequently than on a quarterly basis—weekly, if not daily. Indeed, financial institutions already typically balance their books every night. Why not then consider ways to have this financial information communicated in the same time frame?

There will be objections to encouraging companies to make available unaudited financial information more quickly, but I believe these objections can be met. As it is now, quarterly financial data are unaudited and will remain that way unless the SEC or a new Public Regulatory Board (whose creation the full House has recently authorized) come up with guidelines for more limited audits for more frequently reported data.[4] In any event, the capital markets would become much more volatile if investors came to believe that all unaudited financial information were useless. Even in the wake of Enron, the financial data produced by the overwhelming preponderance of public companies still have use; if this weren't true, stock prices would be well below where they are now. Accordingly, if in an age of computers and the Internet, companies have the ability to publish their financial statements more frequently than every quarter, why shouldn't public policy encourage that result?

I believe there is a potential side benefit to more frequent financial disclosure, and it is related to the problem of earnings management to which I referred earlier. If companies routinely reported their financial results much more frequently than every quarter, it is conceivable that investors and analysts would lose interest in the quarterly figures. It is highly doubtful that analysts would take the trouble to develop earnings forecasts more frequently than on a quarterly basis. Thus, there is a chance that more frequent reporting could reduce incentives of managers—and their auditors—to engage in earnings management.

At the same time, *mandating* more frequent reporting at this point is premature. Many firms simply may not be able to comply with such a requirement, even over a period as long as a month. Or the cost of compliance may be prohibitive. The challenge is to find a way to provide incentives to the firms that *are* able to report more frequently than quarterly. Here, too, the Committee could play a constructive role by asking the SEC

Reporting Forecast, 2000, 1999 (PriceWaterhouseCoopers); Robert S. Kaplan and David P. Norton, *The Balanced Scorecard* (Harvard Business School Press, Boston, 1996).

[4] If this happens, some thought needs to go into adjusting liability thresholds to reflect any differences between the kinds of audits.

to review the options, and at the very least, lead a visible campaign to encourage more rapid reporting more suitable to the Internet age.

The Future of Accounting Standards

Finally, what future is in store for accounting standards? There is a view that the growing use of XBRL, among other developments, could make them irrelevant. After all, if investors and analysts are better able to manipulate and compare both financial and non-financial data themselves, it is conceivable that there will be less demand for standardized reporting.

I do not subscribe to this view, or at least have not yet been persuaded that the publication of more non-financial information, available in easy-to-use computerized formats, will make reporting standards obsolete. At the very least, there is a role for standards-setters to define what constitutes certain reported items, such as revenue, expenses, and the like. Otherwise, investors have no way of making valid comparisons of financial data across companies. More broadly, for the same reason, I believe there will continue to be at least some demand for standardized reporting as well as standardized definitions.

This brings me to the controversial issues surrounding FASB standard-setting. One set of questions relates to the operation of FASB itself: how, if at all, the development of its standards can be accelerated and better insulated from undue political interference. Another key question is whether U.S. policy should continue to require all firms listing their shares in U.S. exchanges to report under GAAP, or to reconcile their financial statements to GAAP if they report under International Accounting Standards (IAS).

I'll conclude with a few thoughts on each of these issues.

The slowness of FASB's standard-setting could be addressed by having the SEC impose deadlines on rule changes, with the threat that the SEC would take action by a date certain if FASB didn't (as former SEC Chief Accountant, Lynn Turner, has proposed). Although I'm clearly not enthusiastic about the SEC taking over the standards-setting function altogether—which could interfere with the other functions the Commissioners perform and not guarantee any better outcomes—there may be value of having the *threat* of occasional SEC rulemaking as a way of keeping FASB's feet to the fire. The SEC could also become more proactive in reviewing, if not actually setting, FASB's rulemaking agenda on a regular basis, which could also help speed things up.

The downside of more active SEC involvement, however, is that it could result in even greater political interference in FASB's activities than already exists—most recently, with respect to FASB's efforts to set standards relating to the expensing of stock options and the accounting treatment of derivatives. There is a respectable view that politics is inherent in any rulemaking process, especially one that is supposed to be in the public interest, and so we should simply live with the fact. Moreover, it can be reasonably claimed that setting accounting standards is not a science and we should stop pretending that it is something so pure that it shouldn't be affected by the views of the profession that applies them nor of the firms that have to abide by them.

At the same time, however, we should remember that the main purpose of accounting standards—at least for publicly held companies—is to protect the interests of *investors*, not accountants and not the firms themselves. Accounting standards should help investors understand all relevant financial facts that will enable them, if they want, to make projections about future cash flows. Where the standards are changed or not implemented out of concern for affected firms rather than investors, who tend not to be organized and who in any event can always choose not to invest in the companies that may be lobbying the Congress or FASB on a particular rule, then the outcome may not be socially desirable.

In short, it is not that politics should be kept out of the rulemaking process—it probably never can be—but that the current system, at times, can too heavily favor narrow interests over the interests of investors as a class (of course, this a problem that is not unique to accounting standards). In theory, putting more investor or public representatives on FASB could help rectify the imbalance. In practice, however, if Congress wants the rules to benefit narrow interests, then there is little that even a more balanced FASB can do.

Similarly, moving the standards-setting function to the SEC is not a panacea because Congress still exercises oversight of the SEC. The same would be true if FASB members were chosen directly by the Commission. As long as the SEC oversees FASB in some way and Congress oversees the SEC, I don't see how politics can be taken out of accounting standards-setting.

In principle, the only option I believe would have a chance of at least making some difference is to move standard-setting to an international body like the International Accounting Standards Board and thus accept international accounting standards (IAS), which the United States thus far has refused to do—largely out of the belief that U.S. GAAP is superior to IAS. Of course, this is not the rationale for moving to international standards that is typically cited. Instead, the case for IAS rests largely on the view that a single set of accounting standards worldwide would eliminate discrepancies in accounting standards across countries, thereby facilitating cross-border movement of capital. In addition, removing sources of uncertainty generated by differences in national accounting conventions should reduce the cost of capital. In the wake of Enron, others also have argued that a system like the IAS that allows accountants more discretion is superior to the heavily rules-based system of U.S. GAAP which seemingly invites circumvention. (Precisely the opposite argument can made, of course, *against* a system that allows more discretion, and thus potentially more freedom for managements to manage their earnings than already exists.)[5]

Whatever the merits of all of these arguments, the key point is that another potential, and possibly unrecognized, advantage of replacing U.S. GAAP with IAS is that it would dilute the political power of American interests—whoever they may be—to influence the outcome of the standard-setting process. Take, for example, the fight over expensing stock options, which FASB was about to implement several years ago before it was stopped by a powerful lobbying campaign from the U.S. high-tech community. If standards were set solely by the IASB, our high-tech firms would make their views felt, but they could well run into significant opposition from standard-setters from other countries. Indeed, it is just for this reason that moving away from U.S. GAAP to IAS, if it were ever seriously considered, almost certainly would arouse strong opposition in this country.[6]

Accordingly, I do not believe that replacing U.S. GAAP with IAS is a politically viable option, even if the IASB, under the strong leadership of Paul Volcker and David

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[5] A widely noted reason for the greater specificity of U.S. GAAP is that it is a response to the greater pressure of securities litigation in the United States than in other countries. If the United States adopted IAS, it is possible, if not likely, that our representatives would push the IASB to make IAS more specific over time for the same reason.

[6] Those who fear a loss of "financial sovereignty" also presumably would weigh in against any move to a single world standard-setter.

Tweedie, among others, convincingly updates IAS in a way that persuades many in this country that the international standards are superior to U.S. GAAP.[7] I hold this belief for another reason: Even if U.S. GAAP were replaced, it is possible, if not likely, that FASB or something like it would continue to exist in order to issue interpretive rulings of the broader principles-based international standards. If this were the case, and I suspect there would be strong pressure to ensure that it would be if U.S. GAAP ever were replaced by IAS, then FASB's interpretive rulings would gradually lead to a U.S. version of IAS, as well as the "international version". If other countries did the same thing, IAS could fragment over time back into multiple national standards.

It is possible, of course, that fragmentation would not occur—that national accounting bodies such as the FASB would simply fade away. Whichever view is right—fragmentation or monopoly—I lean toward a different approach, one that would allow all firms listing on U.S. exchanges to choose which set of standards, IAS or GAAP, they wanted to report under without having to incur the expense of reconciling the reports under the two standards. Like any monopoly, whether private or public, a single standard-setting organization can stultify and be slow to adapt to market developments. Sound familiar? That's one of the main complaints about FASB. With competition, each standard-setter would have a market-based incentive to keep up with the times and not drag its feet. Furthermore, if it really is true that any move to international standards would eventually break down into national versions of those standards (or at least a U.S. version), then some competition is inevitable. Why not simply recognize that to be the outcome right now?

Wouldn't there be a "race to the bottom" if competition in standard-setting is allowed? The post-Enron experience suggests the opposite would occur. Ask GE, IBM, Tyco or any number of other companies whose stock prices were pummeled by investors after the Enron affair became public. Investors (prompted to some degree by the business media) looked at the financial statements of these companies and apparently found their disclosures inadequate. The market encouraged each to become more forthcoming in its disclosures. Based on this most recent experience, I believe it is reasonably likely (although I admit not certain) that if firms had a choice in reporting standards the market

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[7] Volcker is chairman of the trustees of the International Accounting Standards Board and Tweedie is the chairman of the IASB itself.

eventually would punish the standard that analysts, academics and financial commentators would view as the weaker one from an investor protection point of view. For the same reason, I also believe there is a reasonable chance that competition in standards could weaken (although not entirely eliminate) political influence on standard-setting.

What if after a reasonable period of competition one of the standards was driven out of the market, much as has happened in the markets for computer operating systems (for Intel-based personal computers) or video cassette tapes? If that is the result, then so be it. But given the international movement away from U.S. GAAP and toward IAS, it is likely that the loser in any competition would be U.S. GAAP, leaving IAS. But if national standard-setters nonetheless continued to issue interpretations of IAS, then the market would not have moved to a single standard.

There are less radical proposals than pure competition that could nonetheless bring greater competition to the setting of standards. One variation of pure competition, for example, would be to allow firms listing here to choose the standard but then reconcile only the "material" differences between their accounts under GAAP and IAS (if they chose IAS). The SEC could launch a rulemaking to define what subjects might trigger reconciliation—such as the treatment of stock options, differences in revenue recognition, and the like. This option may be more politically palatable in this country than pure competition, although it would inhibit to some degree the listing of foreign companies on U.S. exchanges. This option would also blunt some of the virtues of pure competition between IAS and U.S. GAAP.

Another variation is the mutual recognition approach used in Europe for the regulation of financial institutions. Under this option, U.S. firms listing on a U.S. exchange still would be required to report under U.S. GAAP, but foreign firms would be able to list their shares reporting under IAS. This model would promote more competition than currently exists, but it may not be politically viable unless accompanied by some kind of reconciliation requirement for material matters.

One way to surmount the political problems relating to reconciliation would be to urge both FASB and the IASB to narrow at least some of the differences that now exist between U.S. GAAP and IAS. Without some kind of external pressure to ensure that these differences do get narrowed, however, this approach may not guarantee quick results. Furthermore, while the narrowing of differences would promote harmonization of standards, it would also detract from competition.

The key point on which I wish to conclude is that some variation of competition in reporting standards between U.S. GAAP and IAS would be an improvement over the current situation. It would be likely to encourage standards-setters on both sides of the Atlantic to keep up more rapidly with events in the corporate world, while also serving the interests of investors. Furthermore, notwithstanding the changes in the business environment that call for new kinds of corporate disclosure, I do not believe that the demand for standardized financial reporting will disappear. Indeed, if competition in financial standards survives a market test, I believe there is a good chance that standards-setters eventually will extend their reach into the definition and refinement of the kinds of non-financial measures that are likely to be used more often in the future to better inform investors of the future financial prospects of the companies whose shares they hold or may want to buy.