



## Panel II Discussion — Financial Reporting: Is complexity threatening compliance and clarity?

Producing accounting standards that promote an accurate view of economic reality is a quest with many challenges, not the least of which is the inherent complexity of a financial statement. Yet deconstructing much of this complexity is at the heart of achieving the larger objectives of business reporting—more transparency and clearer management commentary, for example. With useful and reliable financial statements at the center of overall improvements in financial reporting, this panel directed its remarks at the threats posed by complexity to effective compliance and clarity.

Nelson Carvalho, Chairman, Standards Advisory Council to the International Accounting Standards Board, opened the discussion with a question: Does the complexity lie in the financial reporting itself, or does it reflect on usefulness of the information in complex transactions? Robert Pozen, Chairman, MFS Investment Management, suggested that “the fundamental tension that drives complexity is that most preparers want to suppress volatility of earnings and changes in expectation.” Therefore, he said the “mixed attribution” system currently in use drives complexity because its focus is on current value.

In discussing the value of reporting processes in the minds of management and investors, it was noted that there are probably far too many shortsighted transactions that are not in the best interest of the investor, but which are driven by the expectations of next quarter’s forecast. The current system, they observed, appears to be ideally designed for short-term business focus. Pozen said company sensitivity to corporate earnings reports drives investors to a short-term way of thinking about performance. Most of the panelists seem to believe it would be an improvement for companies to view their projections in longer-term periods, such as annually or even every two years rather than quarterly. Longer term accounting could lead investors to rely more on context and the bigger picture—enabling better analysis of a transaction’s impact on reporting, for example. This would pave the way for a clearer evaluation of the cost/benefit equation related to the reporting system.

Jim Quigley said the issue is further complicated by the need for an accounting model that facilitates better communications between management and investors. “This is a successful model that is by nature complex,” he said. The “noble goal,” he continued, is to get comparability into the mix, but this increases further the layers of explanation. If the aim is to change behavior, he said, the profession and regulators have to deal with the root causes behind building rules that aim to avoid “second guessing.” This would help improve the flow of communications about what the essence of the business is, which, in turn, will help management communicate more clearly with their shareholders. “Investors say they want more comparability but less complexity,” Quigley said. “They want the comparability to help them make important capital allocation decisions and to determine better how various operations are performing” both within their country and globally. Achieving a balance be-



tween comparability requirements and reduced complexity will require moving to a principles-based system, he said.

Philip Ameen, Vice President and Comptroller, General Electric Company, said that a lot of the “friction” between wanting more information and less complexity is born out of all the sub-references that have to be developed in accurately describing the reality of the business status. “The results described,” he said, “simply don’t feel to management like what really happened.”

Pozen agreed, noting that on the one hand there are those who say they want a more principles-based and less technically complex approach, while others ask to “do it right” by providing more details. “This may come out of an over-developed desire for certainty,” he said, “because no one wants to be second-guessed by the regulators.” He stated the case for a system that has an optimum level of both rules and principles. In order to move toward a more principled-based system, he proposed, there is need for an appropriate judgment framework—a disciplined approach adopted by bodies such as the SEC and PCAOB—that is capable of helping both to analyze the facts and provide perspective on the judgment behind decisions that are made.

Marten expressed the concern that one difficulty may be an under-representation of the investor community on standard setting bodies—and theirs is the perspective required in order to strike the right balance between complexity of the transaction and clarity of the rules.

Moderator Humphrys raised the question of how substantive a role the fear of litigation plays in promoting “second guessing” and if in fact the market chosen for an IPO might sometimes be determined by litigation-avoidance. Ameen noted that those determined enough to find capital will find it somewhere in the world. The bigger issue, he proposed, is whether the cost of the infrastructure needed to prepare financial statements in accordance with a market’s requirements might be better used elsewhere in the company. “It’s the investors’ decision about how to deploy their capital,” Ameen said, further noting if they seek a market in which certain types and levels of quality of financial statements are needed, then the U.S. might be the best market. If not, there are now many other market choices.

Pozen added that there is clear evidence of these choices being exercised. In just the past year, four of the largest IPOs were listed in China, four in Europe, one in Australia, and one in the U.S. “Litigation cost is a factor,” he said, “but where the money is being raised is a big factor, too. And the U.S. is no longer the only place to do that, as it was for technology capital-raising in 1996.”

Marten suggested that the IPO sponsors have to decide whether the additional cost balances with the benefit of possibly having access to a greater number of investors. He said it seems the SEC has recognized this development, but it remains to be seen if the U.S. can provide balance between protecting investors and keeping



the U.S. as an attractive place to list an IPO. There's been a nod to globalization in enabling non-U.S. investors to access U.S. investment pools, but Ameen pointed out that reporting has to support money going the other way, too. "We issue substantive amounts of debts around the world and we need to be able to access that money. We've previously used GAAP, but that will not always be the case. We will need to do a reconciliation with IFRS," he said.

Another important issue raised by a member of the audience concerned how firms such as Deloitte will ensure they have properly trained their staff to exercise sound professional judgment under a principles-based system, particularly in light of what appears to be a transitioning of responsibilities to professionals who may not have as much formal education in accounting. Jim Quigley responded by pointing out that the skills deployed by his firm come from a variety of sources and experiences—academic studies, in-house training, and on-the-job mentoring and experiences. The search for and deployment of the resources needed to meet reporting needs is a long-term effort, Quigley emphasized, "it will not just happen with a snap of the fingers."

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