

# The Expanded Role of Financial Reporting in Global Markets

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## Abstract

*Financial reporting in global economy is the subject matter of this essay. The present system provides information that is objective, past-oriented, technically precise, and quantitative. What is needed for worldwide information demands in financial markets, however, is a system which recognizes the importance of a qualitative dimension and leans toward relevance in the reliability-relevance tradeoff. Long-term profit projections and plans should be highlighted; professional judgment should take precedence over technical precision.*

## Introduction

*"We tend to do the things that we know how to do, instead of trying to do the things that we ought to do."*  
--Anshen, *Science and Man*, p. 466.

Numbers -- earnings, sales, stock prices, etc. -- are important in financial markets, yet daily there are "happenings" (takeovers, for example) that just can't be explained by numbers alone. More than ever before, future prospects rather than past achievements dominate decision making. In such a market, information needs have changed and continue to do so. Yet the role of accountants in this information system has not changed accordingly. They know how to provide objective, past-oriented, reliable information, and they have continued to do this and to do it well. But, for the most part, accountants haven't tackled the larger issue of what ought to be done -- to expand their traditional role so that they would provide relevant, subjective, future-oriented information to supplement traditional financial statement data.

Given the legal liability of accountants, this response is understandable, yet it may not bode well for the global economy. Investors need information in order to make rational decisions on the allocation of their capital. Financial markets assist the world in allocating resources; and thus they foster economic stability or instability, both short-term and long-term. It's important to analyze and critique the flow of information in financial markets, especially in global economy such as ours. For many companies, channels of information have become greatly extended; communication flows not just across a city, a country, or even a continent -- but across the globe. Many investors, familiar with the market in their

native country only, now "shop around" in a larger arena and regard national boundaries as much less significant than they used to be.

Good information is needed to provide support for pricing mechanisms and foster an efficient allocation of resources. According to Friend (1972, p. 212), "The more complete and more accurate the information, the more likely it is that the consensus price will be a realistic evaluation of the security." Financial reports are, of course, only one part of the total information set available; nevertheless, they are important. We may not be able to achieve a more efficient allocation of worldwide resources without improvements in financial reporting.

Global investors bemoan the fact that there is not a single set of accounting standards worldwide. Various groups are attempting to rectify this situation; and in the meantime, investors and their representatives employ a variety of interim strategies to codify accounting data so that cross-border comparisons can be made. The issue of the general quality of financial reporting is lost in the shuffle. Yet we can't hope to make strides toward more efficient allocation of resources if we are not actively working on better quality in financial reporting (which may involve a different role for accountants) and not just uniformity of standards. The global economy cannot be satisfied with a financial system that is merely mediocre, even if it is uniform. Instead, it must strive for excellence.

This essay critiques financial reporting as presently constituted. It is addressed to those who provide, use,

and regulate financial and economic data in international markets; that is, to accountants, economists, financial theorists, and financial practitioners. An attempt is made to generalize and take a global view, in spite of the fact that each country has its own individualized set of accounting standards. Some systems are more developed than others, although more development -- that is, more sophistication -- does not necessarily mean a "better" system.

Present systems of financial reporting emphasize: 1. quantitative data to the virtual exclusion of qualitative considerations; 2. reliability rather than relevance; 3. short-term over long term results; 4. technical precision over professional judgment. The essay considers each of these four characteristics in turn. The purpose is not to lay blame at the feet of any one group -- accountants, for example -- nor to suggest that there are easy solutions to current problems in the financial communication arena. Instead, the goal is to examine some major characteristics of current reporting and the environment from which they have sprung. If we wish to create a financial reporting system more supportive of the efficient allocation of resources on a global scale, then we may need to reverse some current trends.

### **Emphasis on Quantitative, Rather than Qualitative, Data**

*"Its chief attribute is clearness; it has no marks to express confused notions."* --Fourier, commenting on the limits of mathematical analysis in "The Analytical Theory of Heat."

In today's global economy, most disclosure from individual firms (through financial reports, press releases, speeches by company officials, etc.) is very heavily quantitatively based. Numbers -- whether they be earnings, expenditures, revenues, or stock prices -- dominate. And this is the case whether the numbers deal with past results or future plans. However, one cannot help but wonder: is it possible and/or desirable to tell just about the whole story of past achievements and future plans through numbers rather than words? Lots of important disclosure points may lack the precision necessary for mathematical disclosure; they may not be exactly "confused," as expressed above by Fourier; but they may be uncertain, hard or impossible to quantify, etc. Since so much of investing (both on the part of the manager and the investor of financial markets) is intuitive guesswork, there may be some important facts that are difficult to disclose in any way, much less quantitatively. For the most part, what seems the rule is that if it can't be disclosed quantitatively,

then it just isn't disclosed. This may not be the best way to achieve an efficient allocation of resources.

On the one hand, there probably is an underlying belief that numbers don't lie, that only numbers can give a totally objective and true view. But, it may be the case that numbers omit more than they disclose. For example, Sterling (1980) argues that companies should report market (rather than book) values, since real-world decisions are based on the former, rather than the latter.

Insistence on precision has seemingly kept human resource accounting -- the attempt to regard employees as assets and to measure quantitatively their "growth" as future service potential to the firm -- from getting off the ground. What this means is that it's extraordinarily difficult for outsiders to place any value on management's attempt to provide motivation, morale, and continuing training for its work force. This seems outrageous in world that places so much emphasis on striving toward productivity gains for society as well as the individual worker. Also, as technology becomes more dominant in the work place, human resource issues take on increased importance. Workers have to know their present job well; but, even more importantly, they have to be motivated to accept change, welcome new challenges, and be receptive to learning new and better ways of getting the work done. According to Levitt (1989, p. 8):

*Two great challenges lie increasingly ahead for the modern organization: to have the requisite types and numbers of knowledge workers to do what must be done, and to have an organization in which they will thrive and with which they will want to remain.*

Traditional financial reporting more often than not says nothing about either of these challenges mentioned by Levitt.

The advent of computer technology has fueled the demand for, and supply of, quantitative data. Information that doesn't come in a numerical format (and is not easily convertible to one) has become increasingly difficult to deal with, and consequently there just doesn't seem to be as much demand for it. But the resulting allocation of resources based on the dominance of quantitative data may not be optimally efficient. When the world was "smaller," that is when borders between countries defined investment horizons, perhaps it was easier for an informal disclosure system of qualitative, as opposed to quantitative, data to work effectively. In a global investment economy, this may not be the case.

There seems to be the assumption, perhaps unwarrant-

ed, that words without numbers lack "clout," or perhaps are even used to mask negative results. Maybe this indicates the need for some sort of professional review or evaluation of qualitative data by a professional. Investors know, companies know, we all know, that numbers don't "tell all" about the past achievement and future prospects of the firm. But often we routinely act as if they do -- except for, of course, the occasional startling piece of information (a bankruptcy rumor, for example) that forces us to "see" the numbers in a different light. There may, however, be not enough opportunity for the routine passing along of nonquantitative data from firms to the marketplace.

### Relevance Vs. Reliability

*"I would prefer a rough approximation, vaguely verified, of a truly relevant datum to perfectly precise, perfectly verified irrelevant data."* --Goetz, "Transfer Prices: An Exercise in Relevancy and Goal Congruence," p. 435.

The platonic concept of truth dominates accounting theory and practice; thus, it dominates financial reporting as well. The accountant's job becomes one of reporting the truth that is "out there" -- and this truth is portrayed as existing independently of those who perceive it or attempt to report on it. However, this reduces the subject (the accountant) to a cipher-subject and his/her analysis to a machinelike function. The analysis may be "true" and correct, but it may be devoid of the personalization and application which really makes it useful. In answer to pleas for greater relevance of accounting data, the profession has always taken refuge behind the shelter of reliability. It is questionable whether this is for the benefit of the accountant (who fears a malpractice accusation) or the user who is the beneficiary of the data.

Market values and/or future-oriented data are often rejected for presentation in financial reports because they are not reliable enough. Yet, according to Sterling (1980, p.106), "We're living in an economy that's underutilizing its assets because it doesn't know what their value is." And this is somewhat understandable, in view of the current legal climate with fears of malpractice accusations.

It may be the case that the pendulum has swung too far to the side of reliability. According to the financial press, the takeover movement currently sweeping the globe is fueled, at least partially, by the fact that many corporations are characterized by "hidden" assets. These could range from undervalued real estate to unique human resources. Hopefully, takeovers assign more

"correct" values to assets and ultimately result in better utilization of these assets. But, at the same time, mergers provide very direct indications that financial reporting often provides a very distorted picture of a firm's worth.

Underutilized assets go hand in hand with inefficient resource allocation. It may be the case that for every takeover that is accomplished, there are another ten (or more) firms with incorrect or at least "misleading" financial statements. Perhaps the hidden assets of these firms will remain undiscovered, and this is a loss for the global economy. Tobin (1987, p. 128) has commented, " ... the takeover epidemic is bad news...because it indicates that in absence of takeover bids the market was not fundamental- rational." the overemphasis on reliability at the cost of relevance may provide legal protection for accountants, but it may also be leading to poor resource allocation.

Relegating relevance to a secondary position may not be very rational. According to Whitehead (1967, p. vii), philosophy "...has to insist on the scrutiny of the ultimate ideas and to the whole of the evidence in shaping our cosmological scheme." Like philosophy, accounting must be concerned with "the whole of the evidence." Various kinds of evidence must be brought together to provide meaningful data for users who are informed to the advantages and deficiencies of these various kinds of evidence. Future-oriented data can be clearly presented as such and accompanied by probabilities and confidence levels, so that the reader is informed of just how "certain" the data is or is not. This bringing together of various kinds of evidence may create, for investors, a base of relevant knowledge upon which to base their decisions.

### Short-Term, Rather Than Long-Term Results

*The greater French Marshal Lyautey once asked his gardener to plant a tree. The gardener objected that the tree was slow-growing and would not reach maturity for 100 years. The marshal replied: "In that case, there is no time to lose, plant it this afternoon."* -- Kennedy, as quoted in "Thoughts...on the Business of Life."

Much has been written about the tendency of firms to emphasize the short-term, rather than the long-term. There are simply not enough global resource allocators around willing to "plant" slowly maturing "trees." One of the causes of this trend may be the accounting information relied on by resource allocators. It makes investment decisions, investors, managers, directors, and

governments rely heavily on data generated by accounting systems. This data may not be suitable for task at hand, since the information readily available discriminates, in a subtle way, against long-term investment. Accounting information emphasizes the short-term, the immediate, the past. This is understandable, in view of the traditional emphasis on the accountant's objectivity; but at the same time, the extent of the tradeoff must be considered. The income statement reflect only past profit over a very limited span of time.

Some researchers have argued that markets are highly efficient, using information that goes way beyond financial statements. Yet, it is a worldwide phenomenon that financial markets still place an inordinately large amount of emphasis on earnings. Companies often lobby against new accounting standards, simply because such standards might have harmful effects on the current profit picture, even though they have no effect on cash flow. And the financial press is filled with reports of attempts to "smooth" income and engage in creative accounting techniques to pump up current results. Perhaps this is not unreasonable, when so much investing is done through large, programmed systems in which the computer magically makes choices based on a somewhat limited array of numbers, and there may not be a lot of analysis on what is taking place behind the numbers. In any event, what cannot be denied is that vast numbers of companies as well as individuals and institutional investors behave as if earnings per share are all important. This behavior has to have implications for the efficient allocation of global resources.

Obviously, investing in the long-terms is risky endeavor; but risk can't be avoided by using the traditional yardsticks (earnings per share, e.g.) that measure past performance and don't necessarily tell us anything about the future. During the past forty years, financial theorists and practitioners have developed a number of sophisticated new techniques for measuring and evaluating risk. The use of discounted cash flow, internal rate of return, sensitivity analysis, and simulation have become widespread. But financial reporting on risk really has not kept pace. It seems ironic that, as the global economy supposedly becomes more and more adept at risk management, it increasingly struggles with the attempt to generate enough long-term investment to ensure a healthy future.

Accountants could help the situation by developing some yardsticks for measuring long-terms profitability. Admittedly this is difficult, because in a sense what is being measured (the long-term profit) does not yet exist! Nevertheless, there are some preliminary steps that might begin to remedy the situation of the market's

myopia as far as profits are concerned. The inclusion of more future-oriented data would be a welcome addition to financial reports. According to Stern (1979, p.16), "Investors need and want a statement of corporate objectives and financial policies that describe where the company is heading and how it hopes to get there." He goes on to say that this means "...casting aside the notion that the conventional model of the corporation, which emphasizes such performance measures as sales, earnings and earnings per share, is necessarily a reliable guide to valuing a company."

In order to help investors assess the probabilities of long-term profit, perhaps firms should routinely provide for investors some kind of "innovation report." To a certain extent, it would have to be both subjective and approximate, but this could be frankly admitted. It would be difficult, because the success of efforts to strengthen long-term profitability (for example, management training or research and development) may not be measurable in the usual sense. Drucker (1977, p. 155) argues for the importance of separate measurement of innovation:

*To impose on innovating efforts the measurements, and especially the accounting conventions, that fit ongoing businesses, is misdirection. It cripples the innovative effort the way carrying a one-hundred-pound pack would cripple a six-year old going on a hike....*

Drucker also points out that the DuPont Company, which developed the return-on-investment model in the 1920's, used it as only one part of a larger system of measurement; innovations were kept separate from this famous model.

It seems that, in the global economy, return-on-investment models (and earnings models and share growth models) have become "measurement" in itself and are not one part of a larger system of measurement. Accountants, as providers of financial measures, have to take the initiative to introduce new kinds of financial data, so that global investors are more prepared to make good tradeoffs between long-term and short-term goals. Long-term plans, goals, and profits may receive more attention if they are explicitly recognized in financial reports.

### Technical Precision Vs. Professional Judgment

*...a backward-looking objective system based on historical cost does not adequately disclose the information relevant for security decisions... informal market demand exists for financial disclosure not available in the financial statements,...*

--Kripke, *The SEC and Corporate Disclosure: Regulation in Search of a Purpose*, p. 278.

It seems ironic that we are aiming for a global economy in which each resource is used to its highest capacity, yet accountants are not utilized to their highest potential. Kripke (1979) portrays accountants as talented professionals and bemoans the fact that they are permitted to confine themselves to objective facts of limited relevance, and thus the public does not get the benefit of their thinking on the crucial judgmental questions. Convention, the regulatory climate, and the threat of litigation against professionals have combined to create this strange phenomenon. Accountants are probably the financial market participants who have the clearest understanding of the "true" financial picture of a firm. Having a real knowledge of what constitutes earning and the technical rules related to the constitution of earnings and assets and liabilities as well, they may be in the best position to evaluate the firm. Yet we force them, for the most part, to limit their involvement to a terse and dry recital of statistics and to issue an "opinion" within a very static framework. The choice of words for each kind of opinion issued by the auditor is largely pre-determined; therefore the opinion is characterized by a certain sameness from one company to another. Auditors do not use original language that would more clearly communicate the nuances of each unique situation.

It may be argued that security analysts are the ones in our society who analyze the numbers while the accountants prepare them. Theoretically, that sounds fine; but as rules have become more complicated, one wonders who is able to understand and interpret them -- aside from, of course, the accountants who use them. There are many security analysts who may very well know the basic principles of accounting; but not all the ins, outs, complexities and newest regulations, so it's questionable that they interpret the numbers to greatest advantage.

It's been suggested by some that activities such as income manipulation and "creative" accounting make additional rules necessary. But what seems to happen is that, after the new rules are created, those with technical expertise can still work around them. There will always be accounting loopholes; rules may block the old loopholes but also create new ones. True closure will never be achieved through rules. As Catlett (1980, p.20F) suggests, more judgments on the part of accountants may be what is needed:

*The accounting profession should cast aside its fetish for voluminous rules and recognize that making more*

*subjective judgments in applying established accounting standards is neither to be shunned nor deplored. Such judgments are, in fact, a hallmark of any true profession.*

The 200 words of an auditor's opinion may be too restrictive a vehicle for the expression of a needed judgment on the part of an auditor. At the same time, a move toward more judgment and less rule making could cost us in terms of uniformity and comparability, but the benefits could be worth the cost.

The legal liability of accountants is, of course, an important consideration. If accountants are to become more involved with probabilities and uncertain, future-oriented information, they must be protected when their prediction of the future -- although it may have been honest, knowledgeable, professional, fact-based and logical at the time -- turns out to be wrong. Also, there will be those accountants, hopefully in the minority, who would take advantage of a more free, interpretative stance to bend the rules to their own advantage, giving opinions that most of their peers would agree are unwarranted. Blatant dishonesty exists in any profession; but it's not advisable to set up an entire hierarchy of rules to prevent misrepresentation, especially if these rules result in: 1) a much lower quality of service being provided by the profession to the public; and 2) the evasion of these rules by those with the desire and knowledge to do so!

These difficulties are not insurmountable. Accountants in some countries have begun to be involved, on a limited basis, with forecasts and other future-oriented information. Hopefully, this trend will continue and the very existence of this trend indicates that the problem of legal liability can be handled.

Obviously, accountants do have to exercise judgment in preparing and auditing financial statements; but it's just not enough, considering the education, talent, and skill of accountants. We have to work toward a higher level of judgment, one which will make better use of the unique abilities of accountants. At the same time, we cannot allow so much judgment that unscrupulous "professionals" could fool the market and get away with it. The tradeoff is not easy. Society will have to protect accountants in the case of honest forecasts and interpretations that prove to be wrong. But it will also have to fear them because an abuse of power in purposely exercising bad judgment could be detrimental.

## Conclusion

*The conclusion is simple. One can design an informa-*

tion system around a precise, static decision structure, and for many elementary decision problems in organizations that is a good idea. But the more difficult and more important task for information engineering involves the design of a system for an imprecise, changing decision structure. --March, "Ambiguity and Accounting: The Elusive Link Between Information and Decision Making," p. 42.

As far as accounting is concerned, the conclusion is not so simple! The kind of system March (1987) describes is probably far in the future. Considering the variety of languages, customs, cultures, and governments around the globe, it is amazing that financial markets can operate with any degree of efficiency at all! Yet we have to question the efficacy of formal financial reporting systems when we see, on a daily basis, a barrage of corporate takeovers being contemplated and/or completed, allegedly because financial statements inadequately represent company valuations. As Loomis (1988, p.100) indicates:

*Clearly, the Street's leveraged-buyout artists look right through the published financial statements and see a different picture: a scene in which brand names are worth billions, bad debts are always marked down, and retiree health benefits are sometimes deal-breakers.*

Loomis points out that the published figures are not irrelevant, since "... the findings are the starting point for all they do." Being just a starting point doesn't seem enough for information that's so costly to prepare, audit, and disseminate. Some may argue the acceptability of this, since formal systems of information, no matter how "perfect" will always be accompanied by informal systems. But this doesn't seem like a good defense of the status quo, which: 1) provides information overload in quantitative dimension while neglecting qualitative ones; 2) elevates reliability to a much more favored position than relevance; 3) emphasizes the short-term over the long-term; 4) places much more emphasis on technical precision than professional judgment.

We need to move on to a financial reporting system which recognizes the importance of a qualitative dimension and demands more relevance in the reliability-relevance tradeoff. Long-term profit projections and

plans should be highlighted; professional judgment and understandability should take precedence over technical precision. The quest to develop a different financial reporting system will be arduous, because each "solution" presents a new set of problems. Issues such as the following will have to be considered: exposure to legal liability on the part of accountants, timeliness in the reporting of uncertain plans, competitive disadvantage (in that future-oriented information is revealed to competitors), disclosure mechanisms for reporting uncertain (but relevant) data and the associated probabilities, and channels of communications for updates and changes in previously announced plans.

Teilhard de Chardin (1969, pp. 278-279) once commented, "...with what pettiness of spirit, poverty of means and general haphazardness do we pursue truth in the world today...we behave as though we expected discoveries to fall ready-made from the sky." The discoveries we seek will not fall "ready-made from the sky." It's difficult to imagine, much less design, a relevant financial reporting system -- one which deals with both certainty and uncertainty -- conducive to the efficient allocation of resources in a global economy.

The accountant's role is now viewed as taking a picture at one moment in time and then developing that picture by translating it into numbers. This role is artificial, because time doesn't stand still -- either while the picture is being taken or it is being developed. In other words, accountants have to act in an uncertain, changing, risky environment.

Walker (1980), referring to the health field, comments upon acting in the face of risk as follows: "We operate with unknowns...We must act on the best available evidence because the alternative of waiting for perfect evidence is unacceptable." Accountants, too, must operate with unknowns, rather than being satisfied with the "knowns" that may have already lost a great deal of their importance. It is, after all, convention rather than sound reasoning which dictates that an objective, past-oriented, technically precise, quantitative reporting system is the "best." The efficient allocation of resources is far too important an issue to be left to a decision support system which finds justification in historical roots rather than present and future needs.

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