Enhanced Business Reporting: An Auditing Perspective

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ABSTRACT

The reporting of non-financial business information is highly regarded by valuation experts for better capital allocation decisions in the marketplace. In January 2005, the AICPA created the Enhanced Business Reporting (EBR) Consortium and charged it with developing a framework that will improve the quality, integrity, and transparency of business information in a cost-effective and timely manner. A draft of the EBR framework was completed in October 2005. However, independent auditors may reject many provisions of the framework because auditing costs exceed informational benefits. This study analyzes the current EBR framework from an independent auditor's perspective. Qualitative analysis is used to evaluate the auditing implications of providing EBR disclosures to company stakeholders. The findings indicate that the gains of providing better value oriented EBR information are offset by potential management misrepresentation through highly subjective EBR disclosures. Moreover, many EBR elements are not subject to audit at reasonable cost. The voluntary aspect of EBR makes intercompany and intracompany financial comparisons more difficult.

INTRODUCTION

In December 2002, the AICPA created the Special Committee on Enhanced Business Reporting (EBR) to establish a consortium of investors, creditors, and other stakeholders to improve the quality and transparency of business reporting information. In January 2005, the Special Committee completed its mission by creating the EBR Consortium which includes an independent, international consortium of financial reporting stakeholders. During its tenure, the Special Committee created the Public Companies EBR Task Force and the Private Companies EBR Task Force to support the EBR Consortium. The Public Companies Task Force focused on developing sample EBR reports for public companies; the Private Companies Task Force focused on ensuring the scalability of EBR for private companies.

The mission of the EBR Consortium recognizes the modern informational needs of business stakeholders. The reporting of non-financial business information is highly regarded by valuation experts for better capital allocation decisions in the marketplace (Bovee, et al., 2002). The EBR Consortium is charged with developing a framework that will improve the quality, integrity, and transparency of business information in a cost-effective and timely manner. However, there are many trade-offs in financial reporting, and independent auditors may reject provisions of the current EBR framework because auditing costs exceed informational benefits. This study analyzes the current EBR framework from an independent auditor's perspective, and discusses implementation issues regarding the feasibility of applying EBR principles on a widespread basis.

EBR PHILOSOPHY

The EBR philosophy argues that Generally Accepted Accounting Principles (GAAP) are increasingly irrelevant for modern business decisions because they were developed to describe a different economy (Wallison, 2004). In the early 20th century, GAAP accurately measured the performance of manufacturing enterprises such as those in the automobile and railroad industries. The simple balance sheet valuations and corresponding matching of straightforward revenues and expenses provided ample financial information for investors. However, our modern economy has moved to creating a significant portion of value through intellectual effort. Accordingly, a modern financial reporting system should have a greater focus on the intangible assets associated with intellectual effort such as computer software, production methods, employee skills, etc. While GAAP does recognize certain intangibles (e.g., patents, goodwill), it frequently fails to measure their value as a source of profitability. GAAP requires the expensing of many intangibles, such as research and development, because their value is too speculative to be recorded as an asset. However, expensing bona fide intangibles distorts the matching principle by showing reduced earnings in the current period and inflated earnings in future periods.

The EBR method involves supplementing traditional GAAP financial statements with leading performance indicators that capture the value of business intangibles by focusing on current and future performance rather than historical financial reporting. Such an approach permits a long-term view of a company's prospects and alleviates the constant pressure to meet annual and quarterly earnings expectations. The result is less market volatility, increased corporate efficiency, and more accurate security valuations. The EBR framework develops a model for presenting these supplemental disclosures with the goal of improving the quality, integrity, and transparency of information for investors. Transparency is the ability of stakeholders to understand the current and future prospects of a company (Hannon, 2003).

THE EBR FRAMEWORK

In October 2005, the EBR Consortium published a draft of the EBR framework (EBR Consortium, 2005). This framework provides classifications for performance indicators and qualitative information that is associated with business valuation. Special attention is given to utilizing Extensible Business Reporting Language (XBRL) which is a language for electronic communication of business and financial data (Hoffman and Strand, 2001). The Consortium distributed the framework draft as a starting point for discussion, and recognized that some of its provisions are debatable. The EBR framework is divided along four categories of business reporting information. These categories include the business landscape, strategy, competencies and resources, and performance.

The business landscape dimension focuses on external forces that affect future prospects, and includes evaluating markets served; growth potential; capacity to withstand changes; competitive pressures; technological changes; capital availability; possible effects of litigation; etc. The strategy dimension covers organizational structure; business model goals and timelines; the company's approach to risk management; environmental and social considerations; resource allocation; product lifecycle; etc. The competencies and resources dimension addresses processes for continuous improvement; customer satisfaction; retaining and developing human capital; comparison of research and development expenditures to competitors; intellectual property and its role in company growth; information and technology developments; use of financial and physical assets; etc. Finally, the performance dimension links the business landscape, strategy, and the competencies and resources dimensions to financial performance including profitability and liquidity.

Modern businesses frequently sacrifice long-term performance in order to achieve short-term earnings advances. Treating the symptoms of performance difficulties yields faster results than addressing the underlying causes that create the difficulties. Taking the "long view" of financial reporting is an admirable goal, and is clearly the central motivating factor behind the EBR movement. The EBR framework provides a rich and interesting representation of the complex factors that affect future business performance. Business valuation is predicated on the measurement of future earnings; the EBR framework accurately captures many qualitative and intangible business elements that affect a company's prospects. However, in order to value the EBR framework beyond an academic exercise, one must consider the costs of implementation.

CONSISTENCY AND COMPARABILITY

The voluntary aspect of EBR is troubling. If companies can choose whether to provide EBR disclosures, consistency and comparability will suffer because only companies with favorable EBR profiles will choose to participate. Business stakeholders will be required to compare the financial reporting disclosures of EBR companies with those who only provide standard GAAP financial statements. Accordingly, intercompany financial comparisons are more difficult. Stakeholders will be measuring the inelastic GAAP performance measures against the elastic EBR performance measures. Another troubling aspect of permitting voluntary EBR disclosures concerns the possibility that companies will provide EBR disclosures in one year and then delete them in the following year when previously touted intangible assets fail to materialize. Thus, intracompany financial comparisons are more difficult.

If EBR is to be applied in practice, then participation should be mandatory by all affected companies. The value of having intercompany and intracompany comparability in financial reporting is highly significant for fair valuations in the securities markets. The voluntary aspect of EBR creates a serious conflict with the stated EBR goal of increasing transparency in financial reporting because stakeholders will lack reference points for comparing EBR and non-EBR companies.

EBR FOR PRIVATE COMPANIES

The stated mission of the Private Companies EBR Task Force is to ensure the scalability of EBR for private companies. However, the value of EBR disclosures for private companies is open to question (Tackett, et al., 2007). Stockholders are the primary stakeholder for publicly traded companies, but lenders/creditors are the primary stakeholder for private companies. Short-term fluctuations in firm value are largely irrelevant for private companies. Accordingly, the external reporting needs of public company stockholders include financial information useful for determining firm value, but the external reporting needs of private companies include financial information useful in predicting the likelihood of loan repayment (i.e., cash flows over the life of the loan). Valuation requires far greater precision in earnings measurement than loan repayment because firm valuation is a much more complicated issue. Therefore, public company EBR disclosures provide an added dimension in measuring long-term earnings performance, but these disclosures are generally irrelevant for private companies because they have little impact on lender/creditor decision-making. Lenders/creditors are a good surrogate for other stakeholders such as employees, customers, vendors, local governments, etc.

A significant amount of EBR information is highly useful for private company internal reporting purposes. The Private Companies Task Force indicates that the scope of their research does not encompass private company financial reporting. However, they are developing their framework to accommodate the needs of creditors and other external stakeholders (Private Companies EBR Task Force, 2004). This raises serious questions about mission validity for the Private Companies Task Force. If the Private Companies Task Force utilizes the valuation oriented EBR framework as its underlying model, the resulting Private Company framework will focus on the information needs of the wrong stakeholder group. The correct approach to implementing EBR for private company external stakeholders is to focus on the information needs of lenders/creditors. For example, short-term lenders would find very little useful information in any EBR disclosures. On the other hand, long-term lenders have a time horizon that makes EBR disclosures more relevant. Accordingly, a proper Private Company EBR framework should take into account the changing informational needs of short-term versus long-term stakeholders. The banking and lending community is the proper group to provide feedback on this question.

FINANCIAL REPORTING OR SPIN

Much of the EBR criticism leveled at GAAP fails to take into account the difficulties of objectively measuring and reporting important qualitative business information. The EBR philosophy sounds wonderful in theory, but actually employing EBR is difficult because most of the value of business intangibles is predicated on the occurrence of unknowable future events.

Research and development expenditures are a prime example. GAAP requires that R&D be expensed as incurred; this clearly violates the matching principle. The paradox is explained by recognizing that there is no precise way of measuring R&D because its value is tied to unknowable future events. Accordingly, the principle of conservatism steps in and overrides the need for matching revenues and expenses; the result is a conservative balance sheet valuation. In simple language, it is better to expense R&D and sacrifice the matching principle than to allow management the opportunity to clutter up the balance sheet with worthless assets disguised as R&D. However, EBR recognizes the presentation of R&D as part of its theoretical framework. Yet, what exactly is disclosed beyond a monetary expenditure for research? Any company can spin a public relations oriented justification for spending money on dubious projects. Moreover, independent auditors are unable to prove that dubious "R&D expenditures" are bogus because management can always allude to the possibility of future benefits. The inability to audit the true value of R&D is the primary justification for expensing it as incurred.

Embracing R&D disclosures as part of the EBR framework opens the door for officially sanctioned "spin" in financial reporting. Moreover, R&D is only the tip of the EBR iceberg when it comes to introducing immeasurable business information. The business landscape, strategy, and competencies and resources dimensions are rife with opportunities for management to misrepresent their business prospects in a manner that is difficult to verify by auditors. If history has taught us anything, we know that management will use every opportunity to present a favorable image of corporate performance irrespective of reality (e.g., Enron, et al.).

Under GAAP, management enthusiasm is restrained by objective and measurable reporting standards that are verifiable by independent auditors. The most penetrating criticism of the EBR philosophy concerns the systematic introduction of highly subjective and difficult to measure qualitative financial reporting variables that are not subject to audit at reasonable cost (Pinsker, 2003). Accordingly, the gains of providing better value oriented financial reporting information through EBR are offset by potential management misrepresentation through unverifiable EBR disclosures. Financial reporting may become *less* transparent because investors could have to evaluate a bad earnings quarter against management's EBR disclosures that argue short-term sacrifices were made to achieve long-term business gains. The difficulties with potential management biases are compounded when one considers the need for reporting EBR intangible liabilities.

EBR INTANGIBLE LIABILITIES

Proponents of the EBR philosophy are quick to point out the persuasive arguments favoring the disclosure of intangible assets under EBR (Anderson, et al., 2005). However, there is minimal discussion of the corresponding intangible liabilities. Poor product or service quality; inadequate or improperly focused R&D; poorly trained workers/management; inadequate new-product development processes; high turnover of employees, customers, or suppliers; discriminatory hiring practices; etc. are intangible liabilities under the EBR framework. Other examples include dangerous working conditions; potentially litigious products; product tampering by employees during labor difficulties; antiquated manufacturing processes; potential environmental cleanup; and poor company reputation. Each intangible asset under the EBR framework has a corresponding intangible liability counterpart that should be considered for fair presentation of a company's prospects.

Each company should evaluate their own strengths and weaknesses according to the EBR framework, and report their corresponding intangible assets and liabilities without bias. However, management self-interest could result in EBR disclosures that overstate intangible assets and understate intangible liabilities. Exacerbating this intangible reporting bias, the voluntary nature of EBR can be manipulated to the detriment of transparency (Burnett, et al., 2006). For example, under favorable circumstances, management may provide supplemental EBR information that supports higher company valuations. However, if the circumstances become unfavorable, management declines to participate in the EBR program. A more cosmetically hidden variation of this theme involves having management continue to participate in EBR, but refusing to objectively recognize legitimate intangible EBR liabilities.

The highly subjective nature of the EBR framework provides a rich environment for unscrupulous managers to manipulate "intangible earnings" by taking every opportunity to report intangible assets while avoiding the corresponding intangible liabilities. Independent auditors will be challenged because current Generally Accepted Auditing Standards are designed to audit GAAP financial statements rather than EBR intangible assets and liabilities. Moreover, modifying current auditing procedures to accommodate EBR reporting may be cost prohibitive for reasons discussed below.

THE EBR AUDITOR

If EBR disclosures are implemented, they must be audited by independent CPAs. Current Generally Accepted Auditing Standards provide little guidance in auditing EBR disclosures because auditors have traditionally focused on financial information that can be reasonably observed, calculated, or proven with logical inference (Arens, et al., 2006). For example, actuarial and statistical specialists can be employed by CPAs to estimate the current cost of future medical benefits to employees. However, these specialists are useless for estimating the value of EBR intangibles because most of the reference points used in judging EBR performance variables are ambiguous. Reasonable people can disagree about business landscape factors, correct business strategy, or the competencies and resources available to a company. Moreover, even if there is consensus regarding the existence of intangible assets or liabilities, estimating the potential benefit or loss is frequently an impossible task for management or independent auditors.

Harvey and Lusch (1999) develop a six-step process for assessing off-balance sheet intangible liabilities that can be applied to the problems facing EBR auditors. First, is there persuasive evidence that EBR intangible assets or liabilities exists? The primary mechanism for collecting this information would be an EBR questionnaire. This questionnaire is analogous to the auditor's internal control questionnaire, but management would respond to questions regarding EBR intangibles such as customer relations, corporate reputation, strategic planning, unfavorable working conditions, etc. These questionnaires would be tailored so that different members of management would be queried with relevance to their specific area of expertise. If questionnaire results indicate the existence of possible EBR intangibles, then follow-up interviews are conducted to examine the evidence supporting these assertions. The questionnaires should be designed with recognition that management will be very forthcoming with intangible assets, but less so with intangible liabilities. EBR auditors should also spend significant time querying rank and file employees, customers, suppliers, and industry experts to confirm the assertions of management.

Second, if there are EBR intangible liabilities, to whom are they owed? A poorly trained workforce is an intangible liability, but it does not produce a specific debt to a particular entity. Accordingly, this intangible liability needs to be acknowledged qualitatively; however, there is no need to grapple with a mathematical calculation to measure it. On the other hand, ongoing violations of environmental laws can result in real liabilities to governmental agencies. Liabilities owed to standing organizations must be taken more seriously than loosely organized coalitions of consumers or stockholders. Moreover, the consequences of failing to respond properly to the needs and rights of these organizations or coalitions must be considered when preparing EBR disclosures.

Third, determine the magnitude (where applicable) of EBR intangibles. Specific dollar measurements of EBR intangible assets and liabilities should not be made unless the auditor can undertake a reasonably objective and verifiable process. Moreover, the informational needs of the appropriate stakeholders must be the governing factor when deciding whether to calculate the value of EBR intangibles. Conceptually, EBR intangible assets are measured by evaluating the expected present value of their future cash flows. On the other hand, measuring intangible liabilities such as a company's decision to pursue a bad idea or project must involve the accrual of development costs, replacement costs, and the present value of current and future opportunity costs of the failed project (Caddy, 2000).

Fourth, does the informational infrastructure to systematically report on EBR intangibles for the current and future periods exist at reasonable cost? Unless there is naturally occurring data and information that support the existence of EBR intangibles, cost considerations will be a significant barrier for management and independent auditors.

Fifth, assess the likelihood that specific EBR intangibles will materialize. This likelihood assessment factor will be a major barrier in auditor approval of many EBR disclosures. Misreading these likelihoods can easily change a major intangible liability into an asset, or vice versa. For example, suppose a drug company spends enormous sums pursuing a cure for Alzheimer's disease. If they succeed, there is enormous financial gain, but if they fail, the company is bankrupt. Auditors can review the expenditures and read lab reports, but they cannot reasonably estimate the likelihood of success. The likelihood that EBR intangibles will materialize is frequently a function of changing consumer tastes, unpredictable competitor and supplier actions, shifts in the economy, random fluctuations in technological development, and luck. The very nature of a society driven by intellectual capital is one of instability and unexpected change. Accordingly, auditors must evaluate the likelihood of future events, and only allow the reporting of EBR intangibles if it is probable that material intangible assets or liabilities exist.

Finally, auditors should consider whether the EBR disclosures interface properly with GAAP. Some EBR intangibles may qualify as loss-contingencies, and EBR changes may raise consistency issues in how these contingencies are reported from year to year. Ultimately, the auditor must insure that EBR disclosures support or enhance GAAP financial statements.

The possibility of fraud adds another major complication for EBR auditors. Current auditor training in fraud is confined to defalcation or the deliberate misrepresentation of GAAP financial statements. Fraud specialists in public accounting firms are trained from a forensic accounting perspective; however, EBR fraud opens the door to falsifying experiments, drug tests, research results, etc. In conventional auditing scenarios, auditors are able to recognize when to employ the services of a specialist for actuarial, engineering, or appraisal purposes. However, most independent auditors cannot recognize the telltale signs of fraud in scientific research. Accordingly, these auditors will have difficulties knowing whether to retain the expensive services of research specialists to audit the scientific findings of some EBR disclosures.

CONCLUSION

With a proper perspective, the EBR framework makes a valid contribution to financial reporting. The value of EBR lies in challenging stereotyped GAAP reporting; it allows the financial reporting community to think "outside the box." Intangible assets and liabilities are the wave of the future, and the financial reporting community needs to think long and hard about better ways to effectively report this valuable financial information. However, meaningful gains in this area will be slow because most of the conceptually valid EBR ideas are difficult to audit at reasonable cost.

Ultimately, the financial reporting community must look to auditors for developing better methods of auditing EBR disclosures at reasonable cost. Generally Accepted Auditing Standards must evolve into a more adaptable process that recognizes unconventional auditing methods when evaluating EBR intangibles. Auditors will need to develop a niche along various EBR dimensions. For example, auditors of drug companies may retain specialists in the area of drug research to accurately evaluate and approve the reporting of R&D drug expenditures. Similarly, other specialists may be retained in the areas of organizational structure, environmental impact, computer technology, human resource management, etc. These specialists will not operate in a traditional auditing sense; instead, they will focus on assessing EBR intangibles as *probable* assets or liabilities. After a valid determination that probable assets or liabilities exist, auditors will evaluate the language and method of disclosure in a cautious and consistent manner. Future research should focus on finding better ways to audit EBR disclosures at reasonable cost.

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