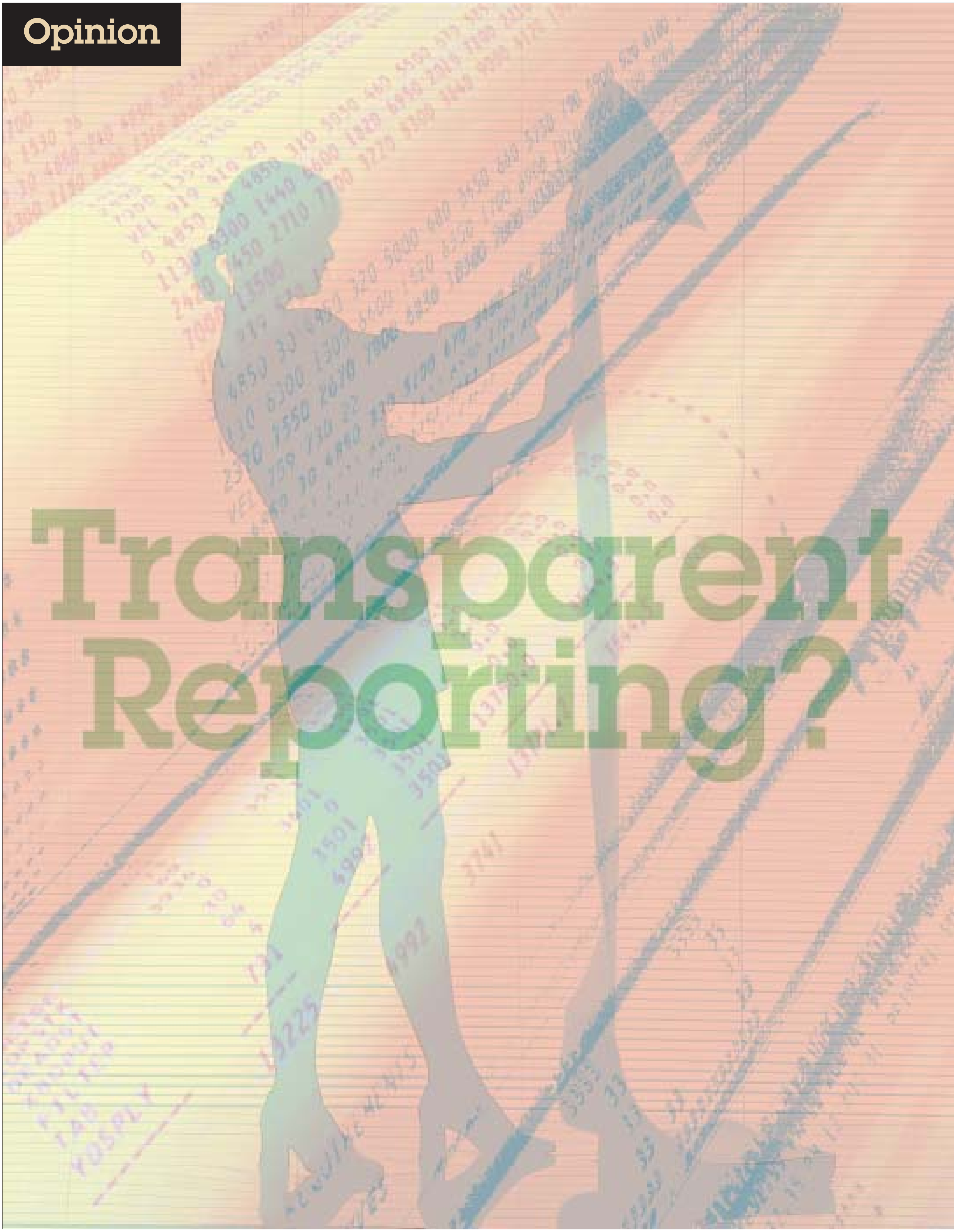
Opinion

Transparent Reporting?



It doesn't equal GAAP compliance.

BY JOHN P. MCALLISTER, CPA

IF A TITLE (like a picture) is worth a thousand words, then IMA President Margaret Butler's "Can Financial Professionals Be Trusted?" (Perspectives, August 2002, p. 5) must be a perfect example. Who would have thought that such a question would ever be raised—even for the express purpose of responding affirmatively?

The financial reporting scandals dominating the news seem to have at least two things in common: greed and dishonesty. Beyond those very disturbing and embarrassing traits, I believe we should consider the possibility of the presence of a pervasive weakness in U.S. accounting and financial reporting, specifically the assumption that compliance with generally accepted accounting principles (GAAP) is the equivalent of transparent reporting.

To facilitate this discussion, I propose several assumptions:

1. Readers of financial statements are reasonably sophisticated investors and creditors.
2. Readers of financial statements expect to receive high-quality information about a company's operating, investing, and financing activities.
3. Information about those activities is reported in the income statement, balance sheet, statement of cash flows, and notes to the financial statements.
4. Preparers and auditors of financial statements have a shared obligation to the readers of financial statements.
5. That obligation is to assure that financial statements are transparent.

While reasonable people might argue for or against one or more of these assumptions, let's save those arguments for another day. This will allow us to focus our attention on transparent financial reporting.

Consistent with the fourth assumption, my use of "we" will refer jointly to preparers and auditors of financial statements. I'll come back to the notion of a shared obligation later.

TRANSPARENCY IN FINANCIAL REPORTING

The term transparent is used in many countries to describe high-quality financial statements. In the wake of the scandals, the term is fast becoming a regular part of our U.S. business vocabulary. My very old college dictionary offers several meanings for this word. Most directly relevant to financial reporting are "…easily understood…very clear…frank…candid." Transparent is further described as being the opposite of opaque, one meaning of which is "…hard to understand, obscure."

When asked by my Kennesaw State University students to relate the "idea" of transparency to the realm of financial reporting, I suggest they consider two extremes:

- Transparency is present when the readers can "see" a company through the financial statements.
- Transparency is absent when readers either can't "see" a company at all through the financial statements or get a distorted view of the company.

Transparency may be a relatively new word in U.S. financial reporting circles, but it certainly isn't a new idea:

- As financial professionals, we have always been expected to choose substance over form.
- The Financial Accounting Standards Board's (FASB) Conceptual Framework includes "representational faithfulness" as one of the essential qualitative characteristics of accounting information.
- The second paragraph of a standard audit report informs readers that "an audit also includes assessing…the overall financial statement presentation."
- The third paragraph of the audit report includes the assertion that "…the financial statements…present fairly…the financial position…results of operations and cash flows."

So, yes, we have always been challenged to communicate in a transparent manner with readers of financial statements.

In my opinion, the likelihood of transparency has been inhibited by our supposition that GAAP compliance is its equivalent. Accounting standards address individual measurement and reporting issues (business combinations, leases, income taxes, and the like) and tend to be quite detailed. From an historical perspective, our seemingly insatiable thirst for detail is understandable in light of two related pressures:

- Criticism that alternative treatments permitted under GAAP facilitated manipulation of results, and
- Our vulnerability to legal liability.

Unfortunately, highly detailed standards and transparency may not be very good bedfellows. The former often results in a checklist/minimalism mentality as in: "Compliance with the details is all we need." The latter calls for a high-quality/best-possible mentality as in: "Let's find the best way to communicate this economic reality." I suggest that our concentration on GAAP compliance has overwhelmed much (if not all) of the concern that we may have with respect to transparency.

Enron's accounting and reporting treatment of special-purpose entities (SPEs) offers an appropriate example. This may be difficult, but, just for a moment, let's presume integrity on the part of Enron's preparers and auditors. Enron's accounting for its SPEs may have complied with the detailed requirements of existing GAAP. But could readers "see" Enron through its financial statements? Of course not. High-quality information about the company's operating, investing, and financing activities wasn't made available to readers. The financial statements were opaque, not transparent. (Note: In January, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities," regarding SPEs, off-balance-sheet structures, and similar entities to offer new guidance on these issues.)

The domination of GAAP compliance over transparency also is evident in a not so obvious context: our general condemnation of the reporting of pro-forma operating results. Criticism is certainly appropriate in those cases where companies sought to use other-than-GAAP presentations to mislead readers. Yet one of the most common pro-forma reporting adjustments (and, in many cases, the largest in sheer dollar size) has been the exclusion of goodwill amortization from the calculation of profit. And now, after careful study, the FASB has concluded that goodwill should *not* be amortized. Hence, is it possible that, at least with respect to this issue, pro-forma reporting might have been more transparent than GAAP reporting?

THE CHALLENGE FOR THE FUTURE

Our challenge for the future emanates clearly from IMA President Butler's question: "Can Financial Professionals Be Trusted?" Yes, I agree with her conclusion that we can be trusted. But—and I'm returning to my idea of shared obligations—I suggest that the following steps are needed to reestablish trust in the financial reporting process:

- CFOs will have to explain to their CEOs and boards of directors that the days of "gaming accounting standards" are over.
- Audit partners will have to explain to their executive offices that audits dominated by accounting standard checklists are over.
- Both groups must publicly acknowledge that they have a shared purpose with respect to financial reporting: *transparency*. A shared purpose should be relatively easy to deal with since we come from common educational, experience, and, perhaps most important, ethical roots.
- Both groups must accept the fact that GAAP compliance is not equivalent to transparency. Financial statements must allow readers to "see" the company. Hence, GAAP compliance is a necessary but not a sufficient condition for high-quality financial reporting.
- The FASB must begin a 100% reconsideration of its standards with the purpose of establishing a "transparency theme" throughout. Furthermore, to assure its continuing consideration, transparency should be defined within the Conceptual Framework's sections on objectives and qualitative characteristics.

Is all of this simply a question of words and theories? I think not. Shareholder litigations are real. Improved transparency should lower their occurrence. Market value penalties for opaque reporting are real. Improved transparency should permit the markets to assess company value more fairly. And last, but certainly not least, our reputations as finance professionals are real. It is up to us to assure that those who rely on us are not disappointed. ■

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