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Have We Lost Our Ability to Improve Financial Reporting?

Here's why standards setters and their constituents are struggling to solve today's financial reporting problems—and how they can be more successful.

Improvements in corporate financial reporting seem frustratingly elusive these days. In particular, the processes by which financial reporting standards are set in the United States and throughout the world don't seem to be delivering improvements that are meaningful, timely, and widely supported by stakeholders. One example is the standards-setting project on lease accounting that's being conducted by the U.S. Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB). The Boards' proposed "improvements" to lease accounting standards—the product of nearly seven years of joint efforts—have been strongly and widely criticized in hundreds of comment letters submitted by preparers, auditors, and users of financial statements.

Contemplating this situation, I began to wonder whether we've lost our ability to improve financial reporting. After more thought, however, I concluded that our ability to improve financial reporting hasn't worsened—rather, the difficulty of the financial reporting problems that we attempt to solve has increased significantly over time. Hence, we've been decreasingly successful at solving financial reporting problems, but not because our ability to solve them has diminished. Our ability simply hasn't kept up with the increasing difficulty of the problems that we're trying to solve.

That was a sobering realization.

Fortunately, I also came to realize that it isn't hopeless. In this month's column, I'll explain how our current situation came to be and describe some things that standards setters and their constituents can do to be more successful at improving financial reporting.

Why Today's Problems Are Harder to Solve

I often tell my clients and students, "If you don't understand the problem, you won't understand how to solve it." From this perspective, the less we understand our problems, the more difficulty we have solving them.

Unfortunately, our individual understanding of the financial reporting problems that we're currently trying to solve is poor, and our collective understanding of those problems is even worse. But this hasn't always been the case. Over time, *financial reporting problems have become harder to understand and therefore harder to solve.*

This is a natural, universal phenomenon. In every realm of human endeavor, problems that are easier to understand—and therefore easier to solve—get solved sooner than problems that are harder to understand and therefore harder to solve. Solving easy problems is sometimes described as "gathering the low-hanging fruit," which typically

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occurs before we direct our attention to the "high-hanging fruit." Once we've solved the easiest problems, the only problems left to solve are the harder ones.

There's a second reason why many of our problems—including financial reporting problems—have gotten harder to solve. Over time, developed and developing societies have increasingly embraced the humanistic value of inclusiveness in governance. As people's diverse perspectives, needs, and capabilities have become better represented in our governance processes, we've attained better solutions to our problems. At the same time, we've found it more difficult to achieve a common understanding of our problems and consensus on appropriate solutions. This doesn't mean we should revert to a less-fair, less-enlightened world—it simply means we should remember that better social behavior often requires more thought and more effort by individual members of society.

Our Problem-Solving Ability Is Stuck in the Past

Even though we naturally take on more-difficult problems over time, we aren't necessarily destined to fail in our attempts to solve them. So why have we been decreasingly successful at solving harder financial reporting problems?

In my experience, techniques that are effective for solving easy problems are often ineffective for solving hard problems. With regard to financial reporting, problem-solving techniques that have been effective against easier problems of the past have proved to be decreasingly effective as our problems have become harder to solve. I believe this is true specifically with regard to the manner in which we attempt to solve financial reporting problems by trying to improve financial reporting standards.

Being stuck in the past isn't an issue for standards setters exclusively.

For example, the standards-setting processes the FASB and the IASB use rely heavily on what I call the "brainstorm and vote" approach to solving problems. This very common approach involves assessing stakeholder sentiment toward proposed changes that tend to be random and incremental in nature. It works decreasingly well as problems become increasingly difficult to understand and solve. Fortunately, there are more-sophisticated problem-solving techniques that have proven effective against complex problems in many fields and that could be brought to bear on complex problems in financial reporting.

Being stuck in the past isn't an issue for standards setters exclusively. Most users of financial information remain fixated on traditional ways of delivering and consuming financial information and thus fail to encourage standards setters to develop truly innovative solutions. In particular, technologies such as eXtensible Business Reporting Language (XBRL) have yet to be widely embraced by users and standards setters for their potential to overcome "disclosure overload" and other contemporary problems in financial reporting. As long as financial-statement users and standards setters continue to focus on 15th Century information technology (i.e., mass-produced pages of static text and numbers presented in a fixed sequence), we really don't have much hope of meeting the information needs of 21st Century decision makers.

So What Can We Do?

To become more successful at improving financial reporting, standards setters and their constituents must recognize that:

- Over time, financial reporting problems have become harder to understand and solve.
- More-inclusive problem-solving processes require more thought, time, and effort than less-inclusive processes.
- Traditional problem-solving techniques and technologies may be ineffective against harder problems.

To solve the financial reporting problems of today and tomorrow, we'll need to adjust our expectations and allocate our resources differently. **SF**

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