Statement of
Rebecca McEnally, CFA Ph.D
Hearing Before the U.S. House of Representatives Committee on Financial Services: Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
"Fostering Accuracy and Transparency in Financial Reporting"
March 29, 2006

Chairman Baker, Ranking Member Kanjorski, and members of the Subcommittee, I am Rebecca McEnally, Director of Capital Markets Policy for the CFA Institute Centre for Financial Market Integrity. The Centre appreciates the opportunity to testify today.

The Centre was established to promote the highest standards of ethics, integrity, and professional excellence in the investment community. It shares this goal with its parent, CFA Institute, which is a non-profit professional membership organization of more than 81,000 members in 126 countries. Our members are engaged in all aspects of the capital markets, including investment advising, portfolio management, financial analysis, and other fiduciary roles. CFA Institute is widely recognized as the organization that administers the CFA examination and awards the CFA Charter, a designation that I share with nearly 68,000 investment professionals worldwide.

High-quality financial information is critical to the work of our members and other investment professionals. So, for more than three decades, CFA Institute members have been actively involved in the public debate about how best to improve financial reporting standards and disclosures. We commend this Subcommittee for your leadership in addressing investors' concerns about the accuracy and transparency of financial reporting.

The corporate reporting scandals and bankruptcies over the past few years underscored how crucial clear, accurate, and complete financial reporting is to the health and well-being of our financial markets. Indeed, these problems reminded us that our markets, currently the strongest in the world, cannot long remain so without such information. Neither can markets survive without investors' trust and confidence that the information upon which they base their investment decisions is accurate, readily understandable, and complete.

The US standard-setters, principally the Financial Accounting Standards Board (FASB) and the Securities Exchange Commission (SEC), as well as the International Accounting Standards Board (IASB), have made progress in the last decade in improving the clarity and accuracy of financial reporting, but they would agree with us that a vast amount remains to be done. To help propel their

efforts forward, the Centre recently released its white paper, *A Comprehensive Business Reporting Model: Financial Reporting for Investors*, developed by our global panel of experts, which outlines 12 principles that we believe would greatly increase the clarity, accuracy and completeness of financial reporting. The complete paper may be found at:
http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2005.n4.4001

I will highlight a few of those principles in this statement. However, I provide a full summary of the twelve principles at the end.

First, we believe that financial statements should be prepared from the perspective of the common shareowner, the last residual claimant on a company's resources. Shareowners cannot properly evaluate a company's potential risks and returns, and value their investments, unless the statements completely and accurately reflect both the assets available to the company and the claims of all others that must be settled before those of the common shareowners.

In this regard, we refer the Subcommittee to the SEC's report submitted to the House Financial Services Committee in June of last year, *Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers.* The items cited in this report as requiring attention are at the top of our current short list, too. We are pleased that the FASB is moving forward on them.

A second principle is that items in the financial statements should be measured at fair value. Under GAAP, the fair value of an asset is the amount at which that asset could be bought or sold in a current transaction between willing parties, other than in a liquidation. On the other side of the balance sheet, the fair value of a liability is the amount at which that liability could be incurred or settled in a current transaction between willing parties, other than in a liquidation. Quoted market price in an active market is the best evidence of fair value and is used as the basis for measurement.

The reason for this is a simple one: the only information that is useful for financial decision-making, including investment decisions, is fair value information. Hence, because financial statements are investors' major source of information, the items in these statements should be measured at fair value. We would add to this, that if most or all items in the statements are measured at fair value, one significant source of complexity in financial reporting would be removed -- that which derives from the mixture of both historical cost and fair value measurement in the same statements.

For example, if all financial instruments were to be measured at fair value, as we have argued for some time, there would no longer be a need for highly complex hedge accounting for positions in the instruments, nor would there be an "accounting" mismatch that can lead to unintended consequences. We were

pleased to learn that the FASB and IASB last October reaffirmed their commitments to fair value reporting for all financial instruments and are working jointly to resolve the remaining issues.

A third principle is that all changes in assets and liabilities must be recorded in a single, new financial statement which we call the "Statement of Changes in Net Assets Available to Common Shareowners." This statement would build upon and expand the reporting in the current income statement. Put simply, no event or transaction which affects the wealth of investors and other claimants on the company should be allowed to escape complete, clear, accurate, and timely recognition in the statement. This means no deferrals of things that have happened, and no items hiding out of sight of investors and other statement users.

Aside from the recommendations in our paper, I also want to comment on several other needed improvements that would benefit investors.

We strongly support the current standards convergence program of the FASB and the IASB. When the day comes that company managers have a single, globally-applicable set of reporting standards, the costs of statement preparation for the various markets in which they raise capital will be significantly reduced, along with one more source of reporting complexity. Obviously, investors will benefit from the reduction because they will not have to try to transform statements from different reporting regions into a single standard in order to perform their analyses.

A current hot topic of discussion is whether company managers should provide quarterly earnings forecasts to analysts, investors, and the markets in general. We recently asked our global membership in an informal questionnaire if this practice should be discontinued, and we were not surprised to learn that of those responding, three-quarters said "Yes, it should be stopped." We also asked those who said "yes" if companies should "provide additional information on the fundamental, longer-term drivers of the business," and 95 percent said "yes." From these results, we conclude that our members find little value in the current earnings guessing-game, but they would value clear, timely information on the basic economic factors that will affect the company and its prospects.

I mentioned earlier that we could reduce one source of reporting complexity by measuring all items at fair value. We have to face the fact that modern businesses are highly complex, and that they engage in very complex transactions. However, one needless source of complexity is the maze of accounting choices currently available to managers for reporting identical or essentially similar transactions and events. If investors are to understand the underlying economics of transactions in the face of so many choices, managers must provide pages and pages of explanatory notes, detailing which choice was made, why, and how the choice was applied, a waste of good managers' time, and investors' analysis time as well. We are pleased that recent reporting standards have diminished these

choices significantly but we believe that much more needs to be done, especially as older standards come under review and revision.

XBRL, eXtensible Business Reporting Language, has much promise for statement preparers and users alike. However, much remains to be done by way of revising and completing the taxonomy so that it is complete and provides consistent, reliable reporting across all companies and industries. Investors do not merely use the numbers in financial statements. Indeed, those numbers are of little use without the understanding needed to interpret them. Hence, the data, tables and explanatory material in the notes to the statements, the "Management Discussion and Analysis," and the other related explanatory materials must be readily accessible in a tagged cell format. Currently, they are accessible in XBRL only as they are in the non-electronic text filings. Developing a complete tagged cell format will take much time and effort, but must be done if XBRL is to realize its full potential and usefulness to investors.

Again, I commend the members of this Subcommittee for your leadership in addressing investors' concerns about the accuracy and transparency in financial reporting and appreciate the opportunity to provide the views of CFA Institute. I am happy to respond to your questions.

Exhibit 1. Summary of the Comprehensive Business Reporting Model Proposed Principles, Current Practices, and Reasons for the Importance of the Proposed Changes

1. **Principle: The company must be viewed from the perspective of a current investor in the company's common equity.**

   Current Practice: Financial reporting standard setters have made significant improvements in financial reporting since the early 1990s. These advances include rules requiring that all derivatives be reported at fair value and that all stock options granted to employees (compensation) be expensed at fair value. But much remains to be done. Many major claims against the company's resources (for example, pension obligations and contingencies) currently escape the balance sheet and income statement and are not fully reported in the notes. Similarly, many revenue-generating assets (for example, receivables, intangibles, and leased assets) are allowed under current rules to escape complete and clear recognition in the financial statements. (See Principle 2)

   Reasons for Importance: The current common shareowner (CCS) is the last to receive a share of the company's net assets (that is, assets in excess of liabilities) and earnings. This means that the claims of all others must be fully satisfied before those of the CCS. Consequently, a CCS must have complete and accurate information about all other claims—including potential risk exposures and possible returns—to value his or her own investment. Similarly, a CCS must understand what assets are controlled and used by the company and the implications of these assets for the company's future growth and financial health.

2. **Principle: Fair value information is the only information relevant for financial decision making.**

   Current Practice: Since the early 1980s, financial reporting standard setters have tended to base new standards on fair value measurement. The FASB, working on its own behalf and that of the IASB, has developed a new

standard for fair value measurement for assets and liabilities and expects to release the final standard in the second quarter of 2006. The CFA Centre strongly supports these efforts, but the majority of standards comprising the bulk of current GAAP are not based on fair value principles. Much work remains to be done to bring these rules into compliance with the FASB's fair value measurement standard.

Reasons for Importance: Decisions about whether to purchase, sell, or hold investments are based upon the fair values of the investments and expectations about future changes in their fair values. Financial statements based on outdated historical costs are less useful for making such assessments. Fair values, by definition, impound all of the most current assessments about the value of an investment and any future changes in that value.

3. **Principle**: **Recognition and disclosure must be determined by the relevance of the information to investment decision making and not based upon measurement reliability alone.**

Current Practice: Although recently developed reporting standards have tended to be designed to provide information relevant to financial decision making, many older standards, which form the bulk of current GAAP, were structured more from a concern for practicability (what was easiest to do and most easily verified) rather than from a consideration of what would constitute the most useful information. Indeed, many companies have now instituted financial analysis divisions responsible for developing the sorts of information investors require but are only used by internal managers. The role of the financial analysis team is to develop timely fair value information so that managers will have the information they require to make their own investment decisions, for example, to acquire assets, expand or reduce operations, or divest portions of the operating activities. Although company managers may be reluctant to provide such information to investors, they recognize that the information is critical for the investment decisions that they when acting as investors must make.

The CFA Centre believes that most standard setters subscribe to the idea that GAAP accounting methods must produce decision-relevant information, but much work remains to achieve this objective.

Reasons for Importance: Financial information may be completely reliable if it is easily verifiable according to one or more criteria. But the information may not be relevant for financial decision making. An example is the purchase by a company of a major manufacturing facility 30 years ago for which the bill of sale is available to support the recorded cost. The recorded cost may, therefore, be considered reliable in the conventional sense. Financial decision makers today, however, would find little that is useful or relevant in that number for the decisions they must make today.

4. **Principle**: **All economic transactions and events should be completely and accurately recognized as they occur in the financial statements.**

Current Practice: Because companies seek to portray themselves in the best light, they sometimes engage in transactions that do not require immediate recognition (such as off-balance-sheet financing). For example, despite amendments of the lease accounting rules by the FASB, many leased assets remain off balance sheet even when the company effectively owns or controls them.

Reasons for Importance: The purpose of financial reporting is to convey the economic position of the company and changes in that position to investors. Reporting methods that omit or fail to reflect the economic essence of events and transactions as they occur do not achieve the purpose of financial reporting.

5. Principle: **Investors' wealth assessments must determine the materiality threshold.**

Current Practice: Despite statements of regulators, including the U.S. SEC, company managers and their auditors tend to apply ad hoc "rules of thumb" when deciding (1) whether certain items are of sufficient size or importance (materiality) to warrant clear, separate reporting and (2) the reporting method to be applied.

For example, some managers and auditors may use as their benchmark 5 percent of a line item, such as net income or total assets or sales. In contrast, we believe that materiality assessments should be based upon whether the item would make a difference to an informed investor. For example, a relatively small amount might change the trend of an expense category. Moreover, related items should be considered in total, rather than individually, to determine materiality.

Reasons for Importance: Financial statements are prepared for those outside the company who need the information and who base their financial decisions upon it (e.g., investors). Consequently, the materiality threshold should be based upon what will affect investors' decisions and not upon preparers' arbitrary assessments. These decisions should be based both on quantitative as well as qualitative factors. For example, even a small amount of fraud committed by company managers would likely be considered to be highly material to investors, who need to assess the integrity of those to whom they have entrusted their assets.

6. Principle: Financial reporting must be neutral.

Current Practice: Reporting standards issued recently tend to honor this principle more faithfully than before. Examples include the recently issued FASB and IASB rules on the expensing of stock options. Many older standards, however, still exist and are applied to major categories of transactions that were heavily influenced by concern about outcomes rather than the imperative to fully report the economic essence of the items.

Reasons for Importance: Reporting of economic transactions and events should not be influenced by the outcomes of the financial reporting or the effects that the reporting may have on one or more interests. For example, in the recent stock options expensing debate, those opposed to expensing argued that expensing stock options as compensation would reduce net income, causing companies that issue stock options to reduce the number of options granted to employees, making

it harder to attract talented employees. The argument was misplaced. All costs of production, including employee compensation, must be reported fairly, completely, and accurately. In the past, concern for outcomes has caused preparers to bring considerable pressure, both directly and indirectly through other political forces, against standard setters to scale back, slow, alter, or abandon standard-setting attempts altogether. One example is the reporting of defined-benefit pension obligations and the cost associated with such plans. The rule as it was initially drafted for reporting such obligations was broadly consistent with fair value recognition. But under the intense pressure of preparers, successive drafts gradually purged all remnants of fair value reporting. Under the final rule, neither the balance sheet nor the income statement reflects the economic position of the plan and changes in that position.

7. Principle: All changes in net assets must be recorded in a single financial statement, the Statement of Changes in Net Assets Available to Common Shareowners.

Current Practice: Changes in net assets are not reported in a single place but are scattered throughout the financial statements, the income statement, cash flow statement, balance sheet, and statement of changes in shareholders' equity. Moreover, the extensive aggregation and netting in the financial statements make analyses to generate many of these numbers all but impossible.

Reasons for Importance: We believe that all such changes should be reported clearly and understandably and in a single statement. Investors must now expend great effort to locate these changes and make use of them. Indeed, because of the high levels of aggregation and the lack of consistency, investors must resort to a great deal of analysis to try to determine the source and magnitude of many changes, if they are able to do so at all.

8. Principle: The Statement of Changes in Net Assets Available to Common Shareowners should include timely recognition of all changes in fair values of assets and liabilities.

Current Practice: Relatively few statement items are required to be recorded at fair value with changes recognized currently in net income. Derivative instruments and securities held for trading are notable examples that meet this test. The rules, however, permit gains and losses for some items that currently are recorded at fair value in the balance sheet (for example, available-for-sale securities and cash flow hedges) to be deferred outside of income.

Reasons for Importance: If investors are to be able to evaluate how the value of their investment in a company is increasing or decreasing, they must be able to fully understand how the company's operations and activities are increasing or decreasing the values of the assets they hold and the obligations they have incurred. The clearest measures of a company's wealth-generating or wealth-consuming patterns are changes in the fair values of these assets and obligations.

9. Principle: The Cash Flow Statement provides information essential to the analysis of a company and should be prepared using the direct method only.

Current Practice: Only a handful of the thousands of public companies worldwide report cash flows using the direct method.

Reasons for Importance: Ultimately, investors value their investments by forecasting the company's future cash flows and cash flow generating ability. A clear picture of the company's current means of generating cash flows, the patterns of inflows and outflows, and its effectiveness in producing cash is essential to this analysis. The current cash flow statements of most companies do not provide this information.

10. Principle: Changes affecting each of the financial statements must be reported and explained on a disaggregated basis.

Current Practice: The financial statements issued by most companies today, from the largest with extensive cross-border operations to very small, narrowly focused startups, tend to be highly summarized and condensed. This is achieved by adding together unlike items to report relatively few line items in the statements, despite the disparate economic attributes of their operations. A

good example is the line item "miscellaneous assets," which is sometimes the largest amount in the balance sheet.

Reasons for Importance: Aggregation of information with different economic attributes, different measurement bases, different trends, and from very different operations results in substantial loss of information. Indeed, the information lost is essential to investors' understanding of a company's financial position, changes in that position, and the implications for valuation of investments.

11. Principle: Individual line items should be reported based upon the nature of the items rather than the function for which they are used.

Current Practice: Information in financial statements, particularly in the income statement but also to a lesser degree in the balance sheet, is aggregated in major functional categories, such as cost of goods sold and selling, general, and administrative activities. This practice began long ago when companies tended to be focused in a single industry or activity and the items aggregated were more nearly homogeneous. Such is not the case today.

Reasons for Importance: The forecasting of individual line items for use in valuation and other decisions requires that they be relatively homogeneous—that is, represent a single economic attribute or an aggregation of very similar attributes. For example, rather than following the current practice of aggregating labor cost, pension costs, raw materials, energy costs, overhead allocations, and the like into cost of goods sold, which mixes items of very different economic characteristics, trends, and measurement bases, the individual categories should be reported. Indeed, investors currently expend much effort to disaggregate such numbers. Because of the limited information available, the calculations require much estimation and result in considerable error, thus affecting the usefulness of the information. Companies reporting under International Accounting Standards are permitted to report expenses based on

either function or nature. So, this is not a new concept.

12. Principle: Disclosures must provide all the additional information investors require to understand the items recognized in the financial statements, their measurement properties, and risk exposures.

Current Practice: Disclosures vary widely in quality and quantity. Older standards frequently provide for scant required disclosures. Some disclosures, for example, those for defined benefit pension plans (and for stock option expensing prior to the enactment of new standards in this area) have been crafted to make up for inadequate financial reporting in those areas.

Reasons for Importance: If investors are to understand the numbers reported in the financial statements, they must have sufficient supplementary disclosures to evaluate the numbers. Such disclosures can include, for example:

- financial reporting methods used;
- models used for estimation and measurement;
- assumptions used;
- sensitivity analyses of point estimates;
- information about risk exposures; and
- information explaining why changes in important items have occurred, and a host of other important disclosure.

In short, the statements are not interpretable without this information. Disclosures should be regarded as being as important to investors' assessments as the recognition and measurement in the statements.