Critique of how to fix financial reporting

This report has been taken from businessweek and is written by David Bogoslaw. He is a graduate form the University of Columbia. His main field of research and reporting includes energy, chemical industry, science and culture.

The basic aim of this report is to identify the loopholes in financial reporting and find solutions to improve the transparency in it. In the wake of current crisis the report has much importance as some of the causes of this recent turmoil I context of financial reporting are discussed.

The report suggests that a major overhaul of the global financial reporting frame work is required. Although many reforms and some basic structural make over are needed but main focus of the report remains the transparency and accuracy in financial information.

Bogoslaw claims that one of the major fact behind this financial crisis is the risky investments which has forced the paper based financial derivative economy to collapse. Banks and mortgage landing companies are the worst victim of this current financial crisis as they have failed to recognise the risk in their products because of the complex nature of the products. The report also tells that some confusing accounting practices have misled the investor by giving wrong and biased information. Most of the financial annalists are regulators are agreed on the basic principle to get the investor's confidence back all the financial institutions will have to improve transparency in their reporting structure.

The author has focused in four major areas where he believes that the financial management of any firm have to look for loopholes and work out the possible solutions to fix them. According to Professor Paul Miller who teaches accounting at the University of Colorado, its time for companies to change their view about capital markets. In the past three decades they have successfully identified some of the major elements for their growth and success but they have failed to recognise the importance of one very important factor. They have managed to build customer loyalty and employee support through better care and incentives. They have also adopted just-in-time supply chain management and effective use of information technology has developed good communication with their suppliers. But he thinks that most of the companies have failed to recognise the importance the forth factor which is capital market. Miller argues that a firm must inform capital market about prospective cash flow and intended use of the gained capital. He argues that little or biased information will have negative effect of firm’s reputation. In his views managers in the capital markets are competent enough to figure out any doubtful financial information provided by the company and are in a better position to take decision about the investment.

William Isaac who has been chairman of the Federal Deposit Insurance Corporation in mid 1980’s blames FABS’s 15 years old rule which requires assets to be valued at their current market value. He believes that this rule puts companies in a difficult position to use this rule when the value of their assets has a temporary decline. This further forces the company to write down their asset values and thus equity is destroyed.

But SEC and FASB have developed a new way to over come this by allowing company’s top management to use their own financial models to value assets when their value has a huge decline in the market.

Miller also focuses on making derivatives more transparent. He argues that its time to regain the investor’s confidence for financial stability.

He believes that some of the financial reporting practices have to be reformed. Off -balance-sheet financing and pension fund accounting practices under U. S GAAP have to be reformed.

IASB and FASB are working together to improve the qualitative characteristics of financial reports, they have successful in the formation of FAS 158 under which pension fund assets and liabilities are shown on the firm’s balance sheet as net amount instead of in footnotes.

In his views, banks now have to introduce plain-vanilla investment products.

Kenneth Scott who is a professor at Stanford University thinks that trust for securitized assets like CMO, s can only be gained by improving transparency among these assets as the current structure of these assets is very complex e. g; CMO, s CDO, s and CDO squared mixed up and they confuse the investor.

The complex structure almost made it impossible for asset managers to calculate the losses in all these assets.

Scotts suggests that to improve the transparency for these complex structured securitized asset there is need of a basic data bank. He thinks that this is the time for us to realise the need of an electronic financial reporting system. A data base which get all the related financial information and process it to make information more accurate and useful, this will further reduce the uncertainty. To achieve this, credit rating agencies can contribute much as they already have data collected which they use to identify the amount of risk associated with individuals and companies when it comes to financial decision making process.

Philip Moyer who is chief executive of EDGAR online, emphasis the use of electronic data base formats. According to him this will give analyst and regulators more time and freedom to analyze the data. XBRL is one the most successful software used by many countries to analyze and compare company's financial data with much ease.

One the other hand Cindy Fornelli, who is executive director of the Washington based Centre for Audit Quality, says that investors need to get more access to tools which can help them to understand deeply the financial statements of any company before making any investment decision. CQA has recently completed a year and half long study which was focused on the possible ways to improve the financial reporting structure. The key participants were investors, company officials former chairman of SEC and a state Attorney General. They suggests that financial reports should identify the key performance indicators for the industry in which the firm is trading. This will enable the investor to compare this with other companies and the overall condition of the industry.

Introduction

I have been asked to write a critique on David Bogoslaw report " how to fix financial reporting". This report has been published in Business Week Online and is important in context of recent financial crisis. Bogoslaw has carefully presented the views of some of the major finance and accounting professionals. Almost 95% of the report is based on the views of these professionals. This report is also a study in the financial crisis and the role of financial reporting in this regard. First I will analyze the key substantive issues raised by the article and then will check the overall reliability of the stated facts and criticism about financial reporting.

Substantive Issues

The report " How to Fix Financial Reporting" has four main substantive issue to look at and they are as follows:

Complexity in derivatives

Capital market ignorance

Role of electronic financial reporting

Off balance sheet financing

Complexity in derivatives

One of the major element which has shaken the investor's trust in the capital market is the complexity which lies in the derivatives. They confuse the investor and it becomes almost impossible for an investor to judge the risk involve in these products. On the other hand Kenneth Scott who is a professor at Stanford University thinks that trust for securitized assets like

CMO, s can only be gained by improving transparency among these assets. The current structure of these assets is very complex as CMO, s CDO, s and CDO squared are pooled together.

The complex structure almost made it impossible for asset managers to calculate the losses in all these assets.

Bogle et al (2009), suggests that in a risk aware culture banks and other lending or mortgage originators must consider the creditworthiness of the borrower. Transparency enables investors to have a reasonable basis for

their views and reveals existing and potential conflicts

of interest.

It is suggested by the report that to get the investors back on track banks now have to introduce plain-vanilla investment products for a short period of time. This seems obvious as banks are mostly hit by this global economics slow down.

According to Derman (2009), banks now have to take time to consider the risk involve with any kind of decision. This can be achieved by reducing the complexity in the financial products. As plain vanilla products are less complex so the investors are more attracted to less complex products as they believe that they are well aware of the risk involved in these products.

Scotts suggests that to improve the transparency for all these complex structured securitized asset there is need of basic data bank. To get such a data bank which have all the information regarding all these asset pools is very difficult.

Capital Market Ignorance

The report suggests that companies have failed to recognise the real importance of the capital market. The relationship between firm’s financial management and the capital market is very important for the success of any firm. According to Professor Paul Miller who teaches accounting at the University of Colorado, its time for companies to change their view about capital markets. In the past three decades they have successfully identified some of the major elements for their growth and success but they have failed to recognise the importance of one very important factor. They have managed to build customer loyalty and employee support through better care and incentives. They have also adopted just-in-time supply chain management and effective use of information technology has developed good communication with their suppliers. But he thinks that most of the companies have failed to recognise the importance the forth factor which is capital market. Miller argues that a firm must inform capital market about prospective cash flow and intended use of the gained capital. He argues that little or biased information will have negative effect of firm’s reputation. In his views managers in the capital markets are competent enough to figure out any doubtful financial information provided by the company and are in a better position to take decision about the investment.

Role of electronic financial reporting

This has been suggested in the report by Scotts that one of the possible way to achieve transparency in some complex structured securitized assets is by using a basic data bank.

He thinks that this is the time for us to realise the need of an electronic financial reporting system. A data base which get all the related financial information and process it to make information more accurate and useful, this will further reduce the uncertainty. To achieve this, credit rating agencies can contribute much as they already have data collected which they use to identify the amount of risk associated with individuals and companies when it comes to financial decision making process.

Philip Moyer who is chief executive of EDGAR online, emphasis the use of

electronic data base formats. According to him this will give analyst and regulators more time and freedom to analyze the data. XBRL is one the most successful software used by many countries to analyze and compare company’s financial data with much ease . most finance executive accepted the Sec mandate on XBRL. Although this software is really helpful in representation of financial data but company has to consider some critical issues in using these products. According to Stuart(2009), its company’s own responsibility to validate data. Finance staff should make sure that the tags in XBRL should match taxonomy and the underlying 10-Q or 10-K before it goes off to SEC.

XBRL has a framework which guides companies to prepare financial statements according International Accounting Standard.

This has been shown in the fig1.

source: http://www. xbrl. org/taxonomy/int/fr/ias/

Off-balance sheet financing and operating lease

Off-balance-sheet financing has been criticised by Miller in this report. He believes that companies take advantage of the current GAAP rules when it comes to the operating lease.

He believes that some of the financial reporting practices have to be reformed. Off -balance-sheet financing and pension fund accounting practices under U. S GAAP have to be reformed.

IASB and FASB are working together to improve the qualitative characteristics of financial reports, they have successful in the formation of FAS 158 under which pension fund assets and liabilities are shown on the firm's balance sheet as net amount instead of in footnotes.

Finance directors prefer operating lease as it makes their balance sheet shrink. As a general rule-of-thumb a lease does not have to be capitalised so long as the net present value of the lease liabilities amounts to less than 90% of the actual value of the asset.

According to Andrew Lennard of Britian's Accounting Board the distinction between operating lease and finance lease is a fine line. If a lease is giving the company control like of ownership then the accounts should reflect that. So all the lease should be on the balance sheet.

This can misled the investors and other stake holders like credit companies as if they capitalise their operating lease their gearing ratios will shoot up.

But off-balance-sheet financing can be a useful tool. This compels the investors to look deeply into the some kind of off-the-book deals. But many companies are reluctant to provide such kind of information. So the key issue remains the disclosure (Feldman,& Amy 2002).

Validity of the implied criticism of corporate financial reporting

To validate any of the criticism made in this article we have to look into the related literature and some the regulation which govern the financial practices in the market. The most important things to consider in this regard is the conceptual framework and qualitative characteristics of financial information.

The qualitative characteristics of financial information defines four main characteristics in any financial information namely; reliability, comparability, understanding and relevance.

The reports says that investor's confidence in markets can only be regained by improving the financial transparency. So basically the author suggests that reliability of the financial information has to be achieved.

For financial information to be reliable it must be free from errors. The presentation should be faithful and neutral. It has to be prudent and complete(Elliott & Elliott 2008).

The author believes that many companies have failed to provide accurate and complete information about their financial standing which is against the qualitative characteristics of financial information.

The report also discuss the off-balance sheet finance and operating leases as the current structure of financial reporting makes it hard for a common investor to recognise and understand the firm's real financial position. We again look this fact from the perspective of qualitative characteristics of financial reporting and come up with the answer that these practices reduce the understandbility of the information.

The report emphasis that it is basic responsibility of firm's management to keep capital markets informed about their financial standing. Deliberately biased information will effect the company's reputation and will have a negative effect on their over all performance. This comes under the objectives of financial reporting as governments and other agencies like capital markets are also the come under one the main user group of firm's financial information in the form of financial statements(Elliott & Elliott 2008)

Conclusions:

Although finance has never been a previous reporting filed for David Bogoslaw but he has produced a very good and comprehensive report on a very complex subject with the help of professional approach. The major part of the report consists of financial and accounting personalities of decent repute which makes this report more attractive. The report basically emphasis the need of more transparency in financial reporting structure. The four major areas of concern in this report are short shrift to capital markets, restructuring of complex derivatives, need for electronic financial reporting and some basic changes in accounting techniques.

The author has been successful in sending his message out about the role of financial reporting in current financial crisis.

Need for a basic financial data base has been conveyed in the report. This data base will not only speed up the process of financial reporting but also make this information more timely and reliable.