

Much needed beacon for investors

By Robert Pozen

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It is almost exactly a year since the Committee to Improve Financial Reporting was launched by the Securities and Exchange Commission and soon we will report back with our recommendations.

Our mandate was to develop proposals to reduce complexity and improve transparency in financial reporting to investors. After the last of several public hearings on July 11, our committee will issue a report in early August with more than 20 practical proposals.

Among these will be several innovative responses to challenges in financial reporting. The debt crisis has driven home the potential to circumvent rules on whether financing entities must be consolidated or may be kept off the sponsor's balance sheet.

Although the Financial Accounting Standards Board (FASB) tightened these rules after Enron, bank sponsors quickly figured out how to keep off their balance sheet almost all entities used in securitising subprime mortgages.

The committee will probably support intermediate approaches, such as keeping part of the entity's liabilities on the sponsor's balance sheet.

The debt crisis has also provoked a heated debate about whether fair market values should be used more or less frequently in accounting. Although it was not feasible to resolve this debate in one year, the committee is likely to endorse an FASB project to divide the income statement into two or more segments – separating earnings based on core operations from the earnings impact of fluctuating market prices.

This would allow investors to understand better the qualitative differences between these two types of earnings, and permit management to explain better volatile quarterly earnings due to drops in security prices.

The increased use of fair value estimates, together with greater emphasis on principles than detailed rules, has highlighted the need to exercise judgment in generating financial reports.

While the committee will not propose a safe harbour, it believes the SEC should provide preparers and auditors with more guidance on how they should exercise accounting judgment.

Thus, the committee will probably ask the SEC to issue a policy statement outlining the steps to be taken in choosing among accounting alternatives. These steps include analysis of material facts, review of relevant literature, and – most importantly – a contemporaneous written explanation of why a particular accounting alternative was chosen.

At the same time, the number of financial restatements has risen dramatically, though there seems to be a decline in the severity of the accounting errors that caused them. During the “dark period” while the restatement process is being completed, which can take up to a year, the company typically issues little information to investors.

The committee advocates the prompt correction and disclosure of all significant errors, but it does not believe that every one should automatically lead to a restatement; rather, a company should amend past financial statements only when they are material to current investors.

The plethora of financial restatements is one of many factors making it more difficult for the average investor to understand reports of public companies filed with the SEC. To make these reports more useful to investors, the committee is considering the utility of a short summary at the front of these reports.

This could also be posted to company websites with hyperlinks to more detailed sections of the report for those who want to delve more deeply on a specific subject. The committee is also likely to encourage public companies to disseminate key performance indicators that capture objectives not quantified in their financial statements.

A key point is that the proposals can be implemented by the SEC or FASB without legislation. The committee has worked closely with them and is hopeful they will adopt our proposals.

Robert Pozen is chair of MFS Investment Management and the SEC's Advisory Committee on Improving Financial Reporting. The views in this article are those of Mr Pozen, and do not necessarily reflect the views of the SEC or other Advisory Committee members.