The Future of Financial Reporting

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> *"Among all forms of mistake, prophecy is the most gratuitous."*
>
> —George Eliot

A few months ago, John Majors of Ernst & Young, LLP asked me to address the inaugural meeting of the Metro New York-New Jersey IASA chapter. "Why not," he asked, "speak on the future of the insurance accounting model?"

I accepted John's request almost as a lark. Why not, indeed? I could sit in a quiet room, turn on some new-age music, stare into space, and see the future. Isn't that how all the futurists do it? Little did I know that this prophecy business is hard work. Fortunately, some very smart people in accounting have been thinking a lot about the future lately. The Financial Accounting Standards Board (FASB) recently completed its first effort at strategic planning and the American Institute of Certified Public Accountants (AICPA) has had distinguished task forces examine the future of the financial reporting model and the auditor's attest function. My comments here draw heavily on all of that work, but like all views expressed by members of the FASB staff, the opinions in this article are my own. They are not, by any stretch of the imagination, official positions of the FASB.

I have taken the liberty of rewording John's original question. Rather than focusing narrowly on the insurance accounting model, I have broadened the field of view to insurance companies' financial reporting. The insurance accounting model will change, or remain the same, to the extent that it serves the needs of financial reporting. With that perspective, I see four areas that may affect financial reporting by insurance companies—valuation and measurement, information about currently unrecognized assets, reporting in international capital markets, and the use of technology to deliver information. I find, though, that I have more questions than prophecies.

Valuation and Measurement Tools

> *"Options bear a strong family resemblance to insurance policies and are often bought and sold for the same reasons. Indeed, if insurance policies were converted into marketable securities, they would be priced in the marketplace exactly as options are priced."* [1]
>
> —Peter L. Bernstein

No, this isn't a lecture about the need for fair value information, at least, not directly. Instead, I ask that you look for a moment at the growth of mathematical valuation techniques and their application to financial transactions. No regulator has imposed these techniques on the financial community. They have been adopted because they serve a real business purpose.

Fischer Black and Myron Scholes published their seminal paper on the valuation of options 23 years ago. They and their academic colleagues provided tools that facilitated new financial instruments and new markets. More than that, these new measurement tools provided powerful new ways to describe and evaluate a range of economic activity. If you review recent academic writings, you will find option-pricing and other mathematical techniques used to evaluate loan defaults and prepayments, contracting problems, abandonment of assets, research and development projects, real estate development, and, yes, insurance.

Nor is all this so much academic rambling. For a real-life study, read the January 1994 *Harvard Business Review* article, "Scientific Management at Merck: An Interview with CFO Judy Lewent." [2]

The development of financial pricing techniques, and the recognition that they are rigorous tools in a variety of applications, raises two sets of questions:

- First, new tools may remove one of the oldest shibboleths in accounting. For years, accountants have said, "That would be nice, but there is no way to measure it." That may have been true once but now we have the means to measure "it," if we want to. And why wouldn't we want to? If financial reporting is the language of business, and managers have begun to use new measurement tools in making decisions, shouldn't financial reporting follow the lead? For insurance accounting, new measurement tools may remove much of the rationale for measuring short-duration liabilities based on their ultimate undiscounted cash flows.
- Second, new measurement tools may raise questions about the need for a special "insurance" model of accounting. Mr. Bernstein is not the first to see a family resemblance between insurance policies and financial options. Actuaries Stephen D'Arcy and Neil Doherty examined option pricing in their 1988 book, *The Financial Theory of Pricing Property-Liability Insurance Contracts.* [3] At a 1995 New York University conference on fair values of insurance liabilities, one speaker after another described insurance as "the options business." If modern option-pricing theory provides more useful and understandable information about an insurer's liabilities, why not adopt it? If an insurance policy is not so different from a written option, and many different types of companies write options, why should insurers have different accounting models for economically similar transactions?

Unrecognized Assets

> *"The components of cost in a product today are largely R&D, intellectual assets and services. The old accounting system, which tells us the cost of material and labor, isn't applicable."* [4]
>
> —Edmund Jenkins, Chairman
> AICPA Special Committee
> on Financial Reporting

More than one business manager has complained that accountants are quick to record liabilities like post-retirement health care and slow to record the value created in a modern business. Some commentators, including SEC Commissioner Steven M.H. Wallman, have expressed concern that the omission of information about research and development, brand names, customer relationships, and other intangible assets diminishes the utility of today's financial statements.

In April 1996, the SEC hosted a two-day conference on financial reporting and intangible assets. Academics, company managers, financial analysts, regulators, and accounting standard setters participated, and many of the presentations were quite impressive. Some companies, like Skandia, already present considerable supplemental information about value creation and intellectual capital. Others, like Dow Chemical, have developed techniques for measuring the value of intellectual assets and employ those valuations in applications ranging from tax reporting to contract negotiation. Academic research has linked indices of customer satisfaction to the performance of a company's stock. Many who participated in the SEC conference looked to those developments and advocated including more information about intangible assets in financial reporting.

Opinion was not unanimous, though. Some participants questioned the benefit of information about intangible assets, especially recognition of those assets in the financial statements. They observed that measurement is costly and difficult and that the short economic life of many high-technology assets militates against the benefit of reporting them in financial statements.

The FASB is committed, as part of its strategic plan, to investigate whether and, if so, how to incorporate information about intangible assets in financial statements. That effort is still in its infancy, but some broad questions have already surfaced.

Which intangible assets are appropriately included in financial statements? Some intangibles have obvious

value, like the Coca-Cola trademark or Disney's Mickey Mouse, and seem to meet the definition of an asset. Others are more difficult to identify clearly.

How should intangible assets be measured? Accounting, after all, is a science of measurement. Our ability to measure separates financial reporting from advertising. Traditional measurements may not be equal to the task, but is financial reporting improved without some information about "how much" or "how many"? If intangible assets are measurable, is historical cost the most relevant measurement attribute? For example, isn't the end value of an R&D project more important than the accumulated cost of the effort?

The insurance industry is no stranger to the question of intangible assets. Deferred policy acquisition costs are a significant item in the balance sheets of many insurers. Life insurance companies often record the "present value of business in force" as an intangible asset in a purchase business combination. The business combination did not create that intangible asset; it simply provided a reason to recognize it in financial statements. But wasn't the asset there all along? Some life insurance companies in the U.K. apparently think so. They have adopted an accounting model known as "embedded value" that records annually an intangible asset similar to the asset recorded in a business combination.

International

> *The ultimate goal of a campaign to internationalize accounting would be a body of superior international accounting standards that was accepted in all countries as GAAP for general purpose financial statements. That goal is beyond reach for the foreseeable future, and progress in the short- and medium-terms will be incremental. Nonetheless, that goal serves as a guide for the FASB's international activities.* [5]

When I came to the FASB in 1984, questions about international accounting standards had a very low priority. Most of our constituents believed that we had plenty to do in setting accounting standards for the U.S. Indeed, some questioned whether it was appropriate for the FASB to devote any resources to international accounting standards.

Today the picture is dramatically different. International activities consume as much time and effort as the Board's major projects. The FASB Mission Statement now includes a commitment to "promote the international comparability of accounting standards concurrent with improving the quality of financial reporting." A Board member attends all meetings of the International Accounting Standards Committee (IASC). One current FASB project (segment reporting) is a joint effort with the Canadian Accounting Standards Board. The Board works actively with its NAFTA counterparts in Canada, Mexico, and Chile. A group known as the "G4+1," which includes the FASB and its counterparts from Australia, Canada, the U.K., and the IASC, meets regularly and has published several research papers on pressing accounting issues.

Why the change? International companies seek to raise capital at the lowest price, without regard to national boundaries. The need to comply with different accounting requirements is a costly impediment. More important, the variety of national accounting standards lowers users' confidence in the published information. That is not necessarily a criticism of other countries' accounting standards, it is simply a recognition that one reporting system is hard enough to follow. Trying to follow six or seven is next to impossible.

In response to calls for international standards, the IASC has committed to reform its standards and produce a set of "core" accounting standards by 1998. The International Organization of Securities Commissions (IOSCO) has agreed to accept the core standards if, in fact, they are completed on time and provide an acceptable product. The SEC, which is a member of IOSCO, has agreed to consider the IASC product but has indicated that it will demand a level of rigor and completeness consistent with the protection of the public interest.

Will the IASC meet its 1998 goal? Nobody knows. It seems an impossibly ambitious program if the objective is to produce carefully deliberated reporting standards. There are serious questions about the quality of IASC deliberations, its process, and the standards produced thus far.

More important, the slogan that IASC standards are "pretty much the same" as U.S. GAAP is simply that, a slogan. They are not the same, and some of the differences are profound. The FASB has recently published, "The IASC-U.S. Comparison Project: A Report on the Similarities and Differences between IASC Standards and U.S. GAAP." I recommend that report to anyone who is interested in the question of international harmonization.

Whether the IASC meets its goal or fails in the attempt, though, the days are past when a U.S. standard setter can operate without regard to developments in other countries. That is a good thing. Our colleagues in other countries, especially those mentioned above, are talented and thoughtful people. The FASB does not have a monopoly on good ideas or accounting problems. By working together, we can avoid unnecessary differences and better understand why some differences persist. By working together, we can also minimize the problem faced by companies when new requirements are issued in one country and not others.

And what about insurance companies? The international picture is even cloudier. There is no international standard on accounting for insurance activities. At its last meeting, the IASC added an insurance accounting project to its agenda. In Europe, the Fédération des Experts Comptables Européens compiled a "Statement of Principles" on insurance accounting for the IASC to use as a starting point. This is a document of breathtaking diversity that might better be called an inventory of practices. For example, the Statement of Principles states the following.

Property-casualty insurance should be accounted for on an annual basis, or a fund basis, or a deferred annual basis, or some of each.

- Life insurance liabilities may be computed using any actuarial method, without restriction.
- Contracts without mortality risk may be accounted for as insurance or investment contracts.
- Acquisition costs may be either deferred and amortized or written off as incurred.

Investments should be carried at either historical cost or fair value.

Electronic Delivery

> *The information highway is being sold to us as delivering information, but what it's really delivering is data. Numbers, bits, bytes, but damned little information. Unlike data, information has utility, timeliness, accuracy, a pedigree. Information, I can trust. ... What's missing is anyone who will say hey, this is no good. Editors serve as barometers of quality, and most of an editor's time is spent saying no.*
>
> —(From a *New York Times* interview with Clifford Stoll)

My last area is not a pitch for the financial information super highway, at least not in its current form. I count myself among the committed users of the Internet. Still, I am often reminded of one of Mr. Stoll's observations in his book "Silicon Snake Oil." He compares a session on the Internet to a dinner of cheese curls. You aren't satisfied when you finish, and you spend a long time in the exercise. (The Internet, however, does not leave yellow stains on your fingers.)

The Internet is a grand way to gather data when other techniques would be inconvenient. If you need a company's annual report at 11:00 p.m. on a Sunday night, you can probably get it from the company's web page. Failing that, there is always the SEC's EDGAR database. That is an improvement to be sure, but your PC is an awfully expensive mailbox. The information you receive is an exact reproduction of the printed annual report, but harder to read. Apart from speed of delivery, nothing has been added. There are a few notable exceptions, like Microsoft's latest effort, but they are exceptions. There is not much future here if financial information on the Internet continues to simply duplicate the traditional printed reports.

Some have suggested that the future of financial reporting is a move away from "one-size-fits-all" financial statements. They see a future in which companies provide databases of information that users can mine for the information they seek. Financial statements will be replaced by navigation aids. Maybe so, but what are financial statements if not navigation aids? What are accountants and auditors if not editors of financial information? We already have the basic materials in hand.

If there is a future for electronic delivery of financial information, and I think there is, we need to consider a few more questions.

Is electronic delivery of financial information the data free-for-all feared by Clifford Stoll, or does it demand standardization? Financial statement users frequently complain about inconsistencies among different companies' presentations. Wouldn't they value information delivered in standardized formats?

Is electronic delivery of financial information best accomplished with descriptive data similar to today's footnotes, or does it demand more rigorous standards of recognition and measurement? We know that screens are an increasingly important part of financial analysis and descriptive footnotes do not fit well into screens. Good disclosure has never compensated for bad

accounting, and that may be even more true in a world of electronic delivery.

Is electronic delivery of financial information valuable for speed, or can it add value by making the information interactive? For example, what if footnote disclosures were hyperlinked to the basic financial statements? A user who is interested in the pension obligation could jump directly to the footnote by clicking on either the balance sheet or the income statement amount. What if financial statements and footnotes that include numerical data were automatically accessible in spreadsheet format?

Is electronic delivery of financial information best suited to the traditional cycle of annual and quarterly reports, or does it offer the opportunity for an "evergreen" document?

Concluding Observation

Maybe I am not such a good prophet after all. A prophet, or a futurist, would not end so many sentences with question marks. On the other hand, all of us who participate in the process of financial reporting—companies and auditors, analysts and other users, standard setters and regulators—will face these questions and issues in the next few years. I know some of the questions, but we will find the answers together.

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