

Audit Committee Brief



Key factors shaping financial reporting The decade ahead

In the United States and other major countries, the first decade of the 21st century ended with a global credit crisis and a number of highly stressed or failed financial institutions. A significant concern that resulted from these events is the ability of financial statements to warn users about the risks of failure, even when the statements are prepared according to applicable accounting guidance.

Indeed, the reported positions of some institutions, questions about the transparency of certain areas, and views expressed by some commentators that portrayals of risk are often incomplete all point to areas where financial reporting might be improved. In addition, various quarters have called for increased regulation, in addition to strengthening financial reporting, to benefit investors and other stakeholders. Audit committees play an important role in overseeing the quality and adequacy of financial reporting disclosures.

Several financial reporting challenges and trends have emerged during the past few years, including three key qualitative characteristics of useful financial reporting: relevance, understandability, and timeliness. These characteristics have long been recognized as essential qualities in supporting financial, investment, and other economic decision making. As it is the audit committee's responsibility to oversee the integrity of the company's financial statements and financial reporting process, it is important that committee members understand these characteristics and work with management to strengthen their company's financial statements.

1. *Relevance*: Reported information must be relevant to aid investors and other users in making decisions based on an entity's financial position, performance, risks, and business prospects.
2. *Understandability*: Financial reports must be clear and avoid unnecessary complexity or inconsistency that may limit the ability of users to comprehend the information.
3. *Timeliness*: In today's fast-moving markets, information must be communicated quickly if it is to be useful in supporting investors' decisions.

The July Audit Committee Brief is a summary of the Deloitte paper: [Key factors shaping financial reporting: The decade ahead.](#)

The perceived lack of relevant, understandable, and timely information may contribute to the low use of financial reports, as indicated by a survey of investors conducted in 2008 by the Office of Investor Education and Advocacy of the U.S. Securities and Exchange

Commission (SEC).¹ Survey results showed that many investors do not read disclosure documents. Respondents indicated that too much legal or technical jargon gets in the way of clarity, the documents can be too long and wordy, and information is sometimes hard to find in the reports.

William Lutz, director of the SEC's 21st Century Disclosure Initiative, cited these findings in a speech at the National Investor Relations Institute in 2009, saying, "A majority of those investors surveyed never actually read the various reports."²

Audit committee members should consider the concepts of relevance, understandability, and timeliness when evaluating the adequacy of their company's financial statement disclosures.

1. Relevance

Investors and other external stakeholders want information that is relevant to the decisions they face. This information can help them answer two questions: What is the expected return on an investment, and what is the potential risk associated with that return?

Despite the vast amount of information included in today's public-company filings and reports, the information may not have been clear enough to provide users with an accurate picture of the true position of some institutions or certain information that would enable them to form such a view may have been missing.

Accounting bodies, such as the International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB), have attempted to address specific issues through ongoing standard-setting projects in areas such as leases, revenue recognition and financial instruments. Also, the SEC continues to work toward enhanced disclosures in certain sections of annual reports through its [Compliance and Disclosure Interpretations](#). Nevertheless, providing investors with deep insight into the operational reality of an entity may require an effort that extends beyond what is currently considered the scope of financial reports.

Many business leaders and accounting professionals want at least to clarify and, preferably, reconcile differences between performance as measured by operational metrics and by financial reports. Many want to focus more on the information that management actually uses to run the business. This calls for clarifying the nature and purpose of performance metrics and financial reports and the proper relationship between the two. This may also call for developing financial reports that capture operational reality, which may entail reporting more non-GAAP and non-financial information.

To what extent should financial reporting aim to capture and present non-financial measures? Some would argue that non-financial information lies beyond the purview of financial reporting and should be excluded from financial reports, and that such information can be disclosed elsewhere, either on an entity's website or in special reports aimed at specific audiences. Others argue that useful non-financial information can only enrich the picture of the entity's financial performance and prospects.

In practice, organizations' increasing use of non-GAAP measures may indicate that some believe that GAAP financial measures may not always provide the most relevant (or even the most reliable) information for investors. That increasing use also may indicate that non-GAAP and non-financial information might also help readers to understand the key drivers of the business and better gauge future returns.

When evaluating financial information, audit committees may want to evaluate whether other financial measures, either GAAP or non-GAAP, would help make the information more relevant. In addition, audit committees should consider compliance with applicable SEC rules and guidance, particularly in regards to disclosure of non-GAAP and other measures, to determine that such measures are not misleading.

¹ *Toward Greater Transparency: Modernizing the Securities and Exchange Commission's Disclosure System*, 21st Century Disclosure Initiative: Staff Report, January 2009

² *Speech by SEC Staff: The Future of Financial Reporting*, William Lutz, Director, 21st Century Disclosure Initiative, U.S. Securities and Exchange Commission, at National Investor Relations Institute, New York Chapter, January 15, 2009

Questions for Audit Committees to Consider

- Does the audit committee anticipate and understand how pending financial reporting and regulatory developments may affect the company?
- Has management determined what non-GAAP measures provide useful information to investors?
- Are all non-GAAP financial measures reconciled to appropriate GAAP measures?
- Is the company's financial reporting infrastructure prepared to handle the significant changes to major accounting areas occurring during the next few years (e.g., leasing, revenue recognition and financial instruments)?
- Can management confirm that no material facts have been omitted or misrepresented?
- Which accounting policies allow for judgment in interpretation leading to differences in application by peer companies?
- Is the internal reporting calendar sufficiently timely?
- Do the key decision makers receive financial information in time to make knowledgeable contributions?

Much of the relevant information concerns risk measures associated with expected returns. Currently, such information is typically included in the MD&A. Relative to the reporting of an entity's financial performance and position, reporting about risks has started to receive significant attention.

Risk information is designed to capture the potential variability of prospective outcomes. Current disclosures about risk may not be adequate to support this objective. The SEC and U.S. GAAP require certain disclosures, including information about risk factors, a sensitivity analysis of financial instruments, potential variations in currency and interest rates, and value at risk. However, these disclosures can fall short because they are often limited to specific risks, such as currency or interest rate fluctuations, and may not provide a comprehensive analysis of broader risks in and across organizations, industries, and market segments.

Risk disclosures might be more useful if the starting point would be to identify the most significant risks the organization faced across its operational, investing, and financing activities. Organizations could then present an aggregate picture of the potential impact of risks on the entity's financial position and performance.

2. Understandability

Two main issues typically affect the understandability of financial statements—complexity and inconsistency. Complexity in reporting may make it difficult for investors, lenders, and creditors to understand an entity's financial position and performance, and may present challenges to preparers, auditors, and other stakeholders. The SEC's Advisory Committee on Improvements to Financial Reporting recognizes two types of complexity: unavoidable and avoidable. Unavoidable complexity arises from the sophistication and intricacy of today's business environment and the transactions or activities of the enterprise itself. Avoidable complexity arises from the difficulties imposed by a financial reporting regime that creates uncertainty in identifying, interpreting, and applying the relevant GAAP. It also arises from the incomparability of financial statements. Ironically, under GAAP, incomparability often stems from "bright-line" rules that are intended to increase comparability. In practice, economically similar transactions can result in dramatically different accounting because small details put similar transactions on opposite sides of a bright line.

Additionally, global comparability has not been achieved due to the large number of accounting frameworks used around the world. This has been an issue of growing importance as trade and capital markets have continued to globalize at an increasing rate in the past decade.

International Financial Reporting Standards (IFRS) have been accepted at an accelerating rate around the world since 2005 when they were adopted as the set of standards to be used by public companies in the European Union. In May 2011, the SEC issued a staff paper, "Exploring a Possible Method of Incorporation," that presents a likely framework for incorporating IFRS into the U.S. financial reporting system. In the staff paper, the SEC staff elaborates on an approach that combines elements of convergence and endorsement, referred to as "condorsement."

Under an endorsement approach, jurisdictions incorporate individual IFRS into their local financial reporting systems in accordance with specified endorsement processes and usually by using specified criteria. The European Union and Australia, among others, follow such an approach. The staff paper notes that the United States would follow similar processes and the FASB and SEC would have specific responsibilities. In particular, the FASB would incorporate newly issued IFRS into U.S. GAAP, and the SEC and the FASB would retain the ability to modify or supplement IFRS when it would be in the public interest or necessary for the protection of investors.

During a transition phase, the framework would follow a convergence approach under which the FASB would bring U.S. GAAP closer to IFRS by addressing and evaluating differences between the sets of standards and incorporating IFRS into U.S. GAAP, with a focus on minimizing transition costs. While the term "U.S. GAAP" would be retained, the ultimate goal of the framework is that, at the end of the transition period, a U.S. issuer compliant with U.S. GAAP would also be able to represent that it is compliant with IFRS as issued by the IASB. Regardless of whether full convergence occurs, audit committees need to be prepared for the significant changes to major areas of accounting that will occur during the next few years as a direct result of the current convergence efforts.

Although this may not be a complete solution, it could reduce complexity and inconsistency in financial reporting. Having companies in most major economies follow a similar set of standards may well enhance the consistency and comparability of financial statements from a global perspective.

When evaluating financial statement disclosures, audit committees can assess whether they are easily understandable and sufficient to describe the company's application of appropriate guidance.

3. Timeliness

No matter how relevant, reliable, simple, and consistent entities make their financial reports, they will not be of much use to stakeholders if they are not timely. The timing and manner in which financial information will be delivered may represent the most profound change ahead.

The trend in reporting is moving away from providing reports and schedules that were developed before the current technology platforms, and toward a demand-driven model where users will receive and retrieve the information they deem most relevant, and on a more real-time basis. Given the existence of potentially enabling technologies, the notion of real-time reporting is gaining broader appeal. However, it raises the issues of the continual controls monitoring and auditing that would be required to ensure the accuracy of the reported data.

The better and more timely the financial information developed by the enterprise, the more effective its operational, risk management, and funding efforts should be. This implies that the priority must be the relevance, understandability, and timeliness of reporting, no matter what initiatives the financial reporting functions undertake in the years ahead, or whatever principles, standards, and systems they adopt.

What might the future hold?

Risk, regulation, competition, globalization, and investors' demands will continue to fuel changes in financial reporting. Given this and the factors and trends previously identified, there are several guiding principles for organizations to consider in the years ahead, regardless of the individual developments that might emerge:

- Oversee the creation of flexible financial information systems that can adapt to change rather than trying to achieve a static state of perfection
- Consider the needs of the users of financial statements and, to the extent possible, go beyond the current focus on compliance to develop systems with the ability to meet those needs
- Adopt an integrated approach to governance and risk management, and develop human and IT systems that support a comprehensive approach to providing financial and non-financial information to users.

The decade ahead does not appear any less challenging than the last. However, with a focus on improving financial disclosures to enhance relevance, understandability, and timeliness, the hope is that financial statement preparers—and users—will be equipped to better navigate the challenges ahead.

Additional Resources

Deloitte's [Key factors shaping financial reporting: The decade ahead](#)

Deloitte's [IFRS: An Update for Boards and Audit Committees](#)

Deloitte's Heads Up: [IFRSs Anyone? SEC Staff Paper Explores Method of Incorporating International Standards Into U.S. Reporting System](#)

Visit the Center for Corporate Governance at www.corpgov.deloitte.com for the latest information for boards of directors and their committees.

To subscribe to the *Audit Committee Brief* and other Deloitte publications, go to <https://deloitte.zettaneer.com/subscriptions/>