

THE FINANCIAL DATABASE: SOURCE OF THE REALITIES UNDERLYING THE TRADITIONAL FINANCIAL STATEMENTS

Leading Versus Lagging Indicators

The accounting profession is by its very nature conservative. In order to assure the independence, reliability, and comparability of financial statements, the profession has adopted a series of rules and procedures to which all Certified Public Accountants are expected to adhere. While these generally accepted accounting procedures are constantly updated, the resulting product, from the simplest compilations to complex audits, has presented essentially the same information in the same format for decades.

The financial, business and investment communities have relied heavily on these presentations of financial information to determine the financial stability of a company, and its current ability to generate a profit and positive cash flow. Presumably these statements can also reveal weaknesses that would warn management, lending institutions, and investors of impending difficulties.

Interestingly, corporate financial professionals and investment analysts are relying on new measures of financial performance. Gary Zeune, CPA, a strategic and financial consultant and author of the book, *The CEO's Complete Guide to Committing Fraud* lists some of these new measures. Among these new barometers are on-time deliveries, percent rework, quality, customer satisfaction, and the rate of innovation.

Among the reasons these new types of information are replacing the traditional financial reporting is that executives, lenders, and investors want leading indicators that can predict performance. In a business climate where the financial position of a company can change quickly due to changes in the market, poor customer service, poor operational controls, or lack of innovation, the lagging information on the traditional financial statement simply does not meet the needs of today's users. It is not up to tracking and reporting on corporate effectiveness in this rapid fire environment. Zeune suggests, "Traditional auditing does not take into account those non-financial keys that today drive financial statements."

Another reason that users of financial statements have begun to rely on other types of reports are what Zeune calls "massive audit failures." Some of these have received considerable public attention. An example in our area is the Pharmor saga. In response to this situation, the American Institute of Certified Public Accountants formed the Special Committee on Financial Reporting to study the needs of users of financial statements. The Committee's preliminary findings were that traditional statements "fail to meet users' critical information needs, in terms of relevance, reliability, comparability and neutrality."

The Committee recommended many changes including:

- **Value Information.** Supplement traditional cost based value of certain assets and liabilities with "fair market value."
- **Segment Information.** Current disaggregated disclosures do not adequately predict earnings and cash flow. Users want segment information on a quarterly basis. Segmented information might be presented by activity, department, or some other sub-division of a business.

- **Core Information.** Users believe that management often manipulates generally accepted accounting practices, by segregating non-recurrent losses as line items, but non-recurrent gains as ordinary income. Users want to segregate non-recurring losses and gains, so that they can determine what kind of stable earnings to expect from a company on an on-going basis.
- **Estimates, Assumptions, and Off-Balance Sheet Risks.** Users want both qualitative and quantitative information about risks and what assumptions management uses in determining material asset and liability amounts in association with those risks.
- **Nonfinancial Performance Measures.** What are the key nonfinancial factors that drive a company's profitability as reported in financial statements?
- **Forward Looking Information.** Users want financial reports to include information about near term opportunities and risks that are relatively quantifiable.

Another permanent committee of the AICPA is investigating ways to standardize the presentation of graphic materials in financial reports. The tradition is rapidly transforming into innovation.

To satisfy these identified needs of management, lenders, investors, and other users of financial reports, accounting professionals are going to have to learn a business' key success factors and how they drive the financial statements. This is as true of accounting services to smaller and medium sized companies, as it is of giant audits. To paraphrase Zeune, accountants understand the business, not just the books. Accountants who fail to do so are doing their job in a vacuum.

In the case of very large companies, Zeune predicts that in the foreseeable future auditors will certify the validity of the database, and users will configure this database any way they want to predict future financial performance. There are also similarities for small to medium-sized companies. Any company employing accounting software possesses a powerful and extensive database, from which can be derived non-traditional reports containing the sort of executive information that larger companies are insisting upon. There are some powerful realities hidden behind the traditional facade of your compilation or review reports. If your accountant is in touch with the innovations affecting his profession, he will be able to help you discover them.