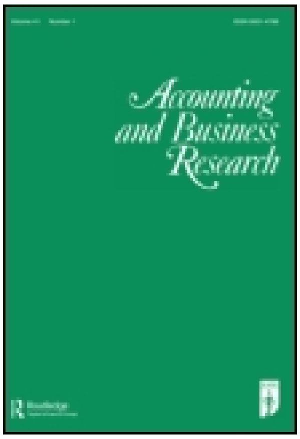

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Overview

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Overview

Lindsay Tomlinson*

At my first meeting at the Financial Reporting Council, one of the members said: 'To resolve this particular issue, we first have to decide what the accounts are for.' Whereupon a more seasoned council member than I raised his hand and pointed out that as the profession had been debating that topic for the last 150 years, we were unlikely to resolve it in the next one-and-a-half hours! The current debate has some of that flavour to it. Our great-great-grandchildren will probably be debating measurement and the use of fair values in 100 years' time, and let us hope doing so in Chartered Accountants' Hall.

I am the first 'normal' practitioner to speak at this conference. Everyone else you have heard from so far is an expert, many of whom make a living from explaining financial reporting to ordinary investment managers like me. It could be said that they are information and disclosure junkies; they just cannot get enough!

As has been pointed out, it has been difficult to engage the end users, the investors, in the accounting standards debate. Why is this? I know it's hard to believe, but many people find the accounting standards debate esoteric and even slightly boring. They obviously haven't attended conferences such as this one.

More plausibly, many investors with an accounting bent are much more interested in exploiting anomalies rather than fixing them. And the killer fact is that, despite all the imperfections, markets do a pretty good job of valuing companies. There are no free lunches out there. One approach might be to ask, as an investor, why spend time trying to fix something that now works tolerably well?

I take a less sanguine view than this. I have great respect for the work done both by academics and by the International Accounting Standards Board in this area. While it is tempting as the practical person to leave the debate to others, I am greatly aware of the truth of Keynes' observation, 'that even the most practical man of affairs is usually in the thrall of some long dead economist'.

This is a deeply important debate. As my contribution, I want to touch on three separate topics: first, about what do investors really care? Second, what is an investor's core activity, and how does that impact on investors' use of financial statements? Third, what has all that to do with the discussions we have enjoyed at this conference?

I have found that there are three things that excite investors in the financial reporting area.

First, they think the accounts should be for them. Investors do not like general-purpose financial statements; we think the accounts should be prepared for the shareholders, the owners of the business, and although we are not the owners (we are actually standing in front of pension fund beneficiaries and insurance policy holders, who are the true owners) we think that the financial reports should be directed to us as, agents of the ultimate owners. And if financial reports are prepared for shareholders, then other users can probably get the information they need from those reports.

Next, stewardship: we as investors want to hold managements to account. Financial reporting has to give us the information we need in order to do so. We want to look backwards as well as forwards.

Third, UK investors are fixated on the true and fair view. That is the principles-based approach. As has been said, in this country we did not have problems such as Enron, WorldCom and Parmalat. We are strongly committed to a principles-based approach and it was fascinating to see Hank Paulson (US Secretary to the Treasury) recently endorsing this approach and suggesting that the US should move in our direction. But in a litigious society like the US, I think rules will continue to hold sway. People need safe harbours. That is a real problem for the convergence project. Investors here lack enthusiasm for convergence to a rules-based approach. It really is a big deal for us.

These are the hot buttons for investors.

I said I would describe what investors actually do. What is our core fundamental activity? Ultimately, we arbitrage between price and value. That is true of any investor operating in public

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markets. For each possible investment such as a company stock or a bond, we know its market price on a continuous basis. We then need to place a value on that stock or bond and make investment decisions based on the difference between the known price and our estimates of the value. We want to find differences between them, and we want to be different to the other investors as well – it's competitive. That is where we add our value.

What are our main tools for estimating value in this game? Basically, there are two; namely net asset value and recurrent earnings. The latter are generally much more important to us, even though I have learnt at this conference that they are impossible to define – it's what we really care about. We are not looking for financial statements to value a company. We want them to give us adequate information to do so. I would contend, as I said at the start, that the market as a whole does a pretty good job of valuing companies. What we are interested in is the underlying business model and the fundamental economics of a business. When we meet companies, we are trying to see them through the eyes of their managements. As Philip Broadley commented, when we meet we talk about the business, not about accounting treatment, except when we really have to – that discussion is generally a two-minute coda to a meeting. We are really trying to understand what is going on within the business, not within the financial statements.

One other important point is that we are particularly interested in something that was not much talked about yesterday, which is cash generation. That is what really cuts through to the fundamental economics of a business. I follow George Orwell's lead in this. He took the famous biblical passage in 1 Corinthians about 'love', and substituted 'money' for 'love'. He was proving a point about capitalism. But, if you substitute 'cash' for 'love', you get pretty close to where the investors stand on this. Cash generation is incredibly important to us. It cuts through all the quirks of accounting treatments.

Finally, what has all this to do with the papers presented to this conference (which, by the way, I thought were uniformly excellent)? I am not sure to what extent we are now violently agreeing with ourselves, but I get the strong impression that there is a 'fair value' camp that wants to place a fair value on everything. Parenthetically I would mention that the term 'fair value' is very prejudicial – we should say 'modelled market value' in this context. There is a pragmatist camp consisting of people who are happy to fair value financial instruments and other market assets, but who want to stick with historic cost transaction reporting. That was exemplified by the debate between Mary Barth and Stephen Cooper yesterday. It is no surprise that I sit firmly in the second camp. I do not think we need to transform what we are doing; I think we should incrementally fix the problems we come across, rather than seek to move to a completely different framework. It may be that all of us are actually in agreement on that, but it is not at all clear to me that this is the case.

Stephen Penman's paper was most helpful in explaining why fair values give me such a problem. As I said, I want to value the company and I do not want it done for me. And I want to use income as the predominant factor in so doing. Taking away my income numbers will remove the major tool I want to use. It is no wonder that investors find this so perplexing.

As a final aside, it is gratifying that people have been able to prove to themselves that management will bias numbers in their favour if they are given the latitude to do so.

Where do we go from here? I am in agreement that much more research will help, but I suggest one useful research project would be to examine the way that investors view financial statements. There is quite a commonality of view between the preparers (the corporates) and the users (the investors). Looking at how each of those operates would be a major contribution to the debate. Thanks again for giving me the opportunity of contributing.