

Measuring Assets and Liabilities Investment Professionals' Views

February 2007



“This research is an important contribution to the fair value debate and will be examined with interest by the IASB.”

Sir David Tweedie, Chairman, International Accounting Standards Board

Introduction

In July 2006, the FASB and IASB jointly issued a discussion paper entitled "Preliminary Views on an improved Conceptual Framework for Financial Reporting". This paper, the first of a series, is a major step in the evolution of financial reporting. It challenges key stakeholders to debate the objective of financial statements. Whose needs should standard setters serve? Does stewardship have a role in the reporting model? What are the qualitative attributes that determine whether information is decision-useful? The answers to these questions will have profound consequences for financial reporting for years to come.

One of the key points to be debated as part of the proposed revisions to the Conceptual Framework is the purpose of the balance sheet and its interaction with the other primary financial statements. What information do users expect to derive from the balance sheet as they assess a company's financial performance and, accordingly, how should assets and liabilities be measured in this statement? To date, the Conceptual Framework does not articulate a comprehensive set of criteria for determining the appropriate measurement bases for assets and liabilities.

The outcome of this measurement debate will impact not just the amounts represented on the balance sheet; it will also have direct consequences for the other primary statements. For instance, when assets are measured at fair value, how should the change in fair value be recognised in the income statement?

Given the scope and importance of these questions, input from professional investors is a necessary part of the solution.



Talking with Investors



PricewaterhouseCoopers met in late 2006 with over 50 buy-side and sell-side investment professionals in Boston, London, and New York, as well as a small number of investors based in San Francisco, Frankfurt, and Toronto. The two objectives of the interviews were to discuss their use of the balance sheet in their analysis of performance and, secondly, the measurement bases for assets and liabilities that best suit their needs. Approximately a quarter of respondents to this survey were “generalists”, either accounting and finance specialists or senior portfolio managers.

The balance of the participants provided insights from the perspective of their industry speciality, including those covering the automotive, financial services, retail, software, and infocomm sectors. *The results should not be considered to be statistically valid.* However, the consistency of views expressed provides valuable insight into both the role of the balance sheet in the investment process and the measurement bases that best meet these users' needs.

The following themes and observations regarding the use of variations of either historical cost or current value measures are specifically focused on their use for illiquid assets and liabilities (for example, PP&E, intangible assets, etc.). Generally, interviewees agreed with the use of current value measures for liquid financial instruments, except long-term debt, as discussed below. Participants were encouraged to avoid using the generic terms historical cost, fair value, or current value, and were invited instead to focus on more granular terms such as entry price, exit price, original cost, replacement cost, etc.

Forecasting Balance Sheets

These investors generally did not believe a fundamental re-evaluation of measurement bases used in accounting for assets and liabilities to be a high priority. Instead, the participants want a more transparent view into the underlying operating performance of a business – that is, greater clarity as to the investment returns generated by management as they convert the inputs of production into revenue.

The respondents generally placed more emphasis upon the income statement in their assessment

of performance, which is consistent with the fact that only 17 percent of respondents actually elect to forecast the balance sheet as part of their analytical process. However, this focus does not mean that they ignore all items in the balance sheet. They focus on specific numbers that help them assess, for example:

- Return on invested capital
- Cash flow
- Indebtedness.

Moving to Current Value Measurement Bases

Respondents are satisfied with the use of current value measures for highly liquid financial assets. However, there are pervasive concerns about the adoption of any form of current value measurement for illiquid assets and many liabilities:

- Whilst respondents generally welcome a current value for liquid financial assets and for those assets deemed to be “investments” or “available for sale”, they question the relevance of current value measures for a number of assets that are “operational” in nature.
- Interviewees are concerned about managements' ability to provide reliable estimates of current value and the potential for changes in current value estimates to mask operating performance, given the current presentation of the income statement.

- Many participants found it unsettling that by measuring liabilities using current value, a deterioration in credit rating results in a gain to the company and an increase in shareholders' wealth.
- Interviewees are concerned about the potential cost of implementing current value measures: Might management's time be better spent?
- Respondents view the task of estimating the current value of the enterprise as theirs, not the role of management and/or accountants.

If a current value measure is to be provided, participants want:

- Key assumptions/drivers to be disclosed in order to compare across companies and evaluate sensitivity and reasonableness.
- Gains and losses on remeasurement of current value to be excluded from the operating performance of the business, that is, most interviewees want to see current measures reported through incremental disclosure rather than recorded in the primary statements.
- Ranges of outcomes, provided through additional disclosure, rather than point estimates.
- Benchmarking against industry norms.

Key Findings

In the Review of Findings we offer line-by-line analysis of the findings. However, some high-level observations can be made:

- Some equity respondents are interested in disclosure of the replacement cost of property so that they might better understand the adequacy of capital expenditure rates and whether management is utilising the assets efficiently. Few wish to see replacement cost on the face of the primary financial statements.
- Fixed income respondents wish to see disclosure in the notes of a “best possible use” sale price for key assets which might be used to repay outstanding liabilities.
- None of the respondents uses balance sheet information on acquired intangible assets – for example, customer lists or brands. The majority of interviewees believe that the current allocation of purchase price, required under both IFRS and US GAAP, does not provide useful information.
- A few in technology-dependent industries think that research and development (R&D) should be capitalised. However, they are in the minority; most express the desire to see R&D expensed in the income statement. There is near-unanimity that disclosure of the total cash spend on R&D would be helpful.
- Inventory, receivables, and payables are generally considered to be adequately reported, although many call for improved disclosure of changes and trends. (Note: The survey did not extend to analysts in industries where inventory is typically held for prolonged periods.)
- Ninety-six percent of respondents wish the accounting for provisions* to reflect only probable events on the balance sheet. However, many interviewees comment that additional disclosure of other improbable but potentially material events would be useful information.
- Eighty-six percent of interviewees want debt to be measured at par value in the balance sheet rather than current value.
- Within the group of participants for whom operating leases are important, there is a near-unanimous desire for such leases to be capitalised on the face of the balance sheet.
- The reporting of taxes is universally deemed to be highly complex. For this reason, deferred tax information is typically ignored. Participants recognise the importance of taxes, but have significant difficulty in identifying cash taxes versus deferred taxes and what they should expect future cash taxes to be.
- Participants are unanimous in their desire to see the underlying economics of pension plans clearly reflected in the financials. There is little unanimity, however, in the solutions proposed by the respondents.

* Provisions is defined for purposes of this report as all liabilities of the organisation excluding long-term debt and deferred tax liabilities. Therefore it would include, for example, accruals, pension liabilities and contingencies.

Review of Findings

“I don’t know if performance is best described as the difference between two balance sheets, but I think it’s helpful as there’s always a lot going on. That’s why all of the primary statements are so important to look at together.”

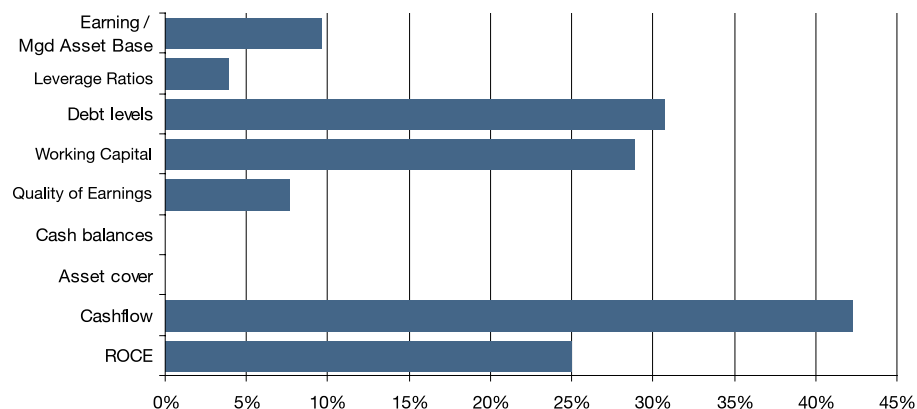
What is the balance sheet for?

This is an important question that many respondents had difficulty answering. Generally, their focus is on either cash flows or earnings or both, and the balance sheet provides relevant information in these regards, but none of the respondents treats the balance sheet as a primary focus. Performance is not viewed by these professional investors as the difference between two balance sheets.

The use to which balance sheet information is put varies, as shown in Figure 1.

The most common use for a balance sheet is as an input to a cash flow model. In this regard, it is the individual line items that are useful rather than the balance sheet as a whole. Very few of our respondents (17 percent) therefore choose to forecast whole balance sheets. A further 17 percent forecast whole balance sheets only because they are required to do so by their investment houses or because this is a necessary input to their modelling systems. Twenty-eight percent forecast specific line items, but the largest number of respondents (38 percent) state that they do not forecast balance sheets.

Figure 1: How do you use balance sheet data?



The responses on individual line items are discussed below. Generally speaking, there is little appetite for greater use of current value in the primary statements, although enhanced disclosure would seem to be welcome.

In the sections that follow, we summarise the survey results with respect to certain balance sheet line items, namely:

- PP&E
- Goodwill
- Other intangibles
- Working capital
- Provisions
- Debt.

PP&E

The majority of survey respondents do not explicitly include the balance sheet amount for PP&E in their investment analysis. Thirty percent of respondents describe PP&E as “very useful” and 57 percent as “not useful”. As one might expect, PP&E is considered to be useful in the more asset-intensive businesses, such as automotive (83 percent) and retail (100 percent). Conversely, every respondent in the financial services sector describes PP&E as “not useful”.

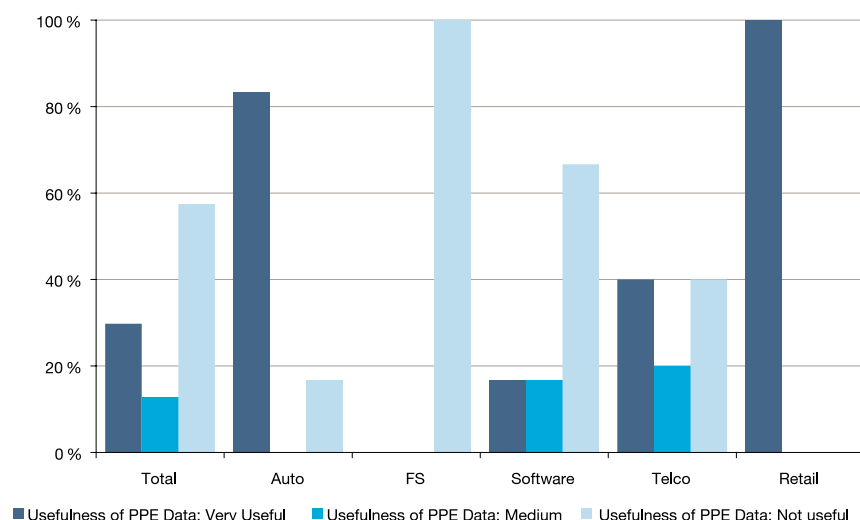
Where PP&E is considered useful, the reasons vary. Most commonly (43 percent), the relationship between capital expenditure and depreciation is an input to cash flow modelling.

“If we lost sight of the actual cost base, that would be the biggest loss to investors.”

“I really do think market values, fair values, have their place – but selectively.”

“Investors do not want the accountants valuing companies for them. That’s what investors do.”

Figure 2: How useful is PP&E data?



Review of Findings

“We wouldn’t value what they have in terms of PP&E. It’s more a case of how much did it cost? How much more are they going to spend on it?”

“I would love to see a footnote on capital expenditures, breaking these things out into more detail in terms of maintenance and investment capex and where it has gone.”

“Goodwill is relevant from a sentiment point of view – what has the company been doing over the last few years? It tells you the history. But in terms of valuing a company, it is irrelevant.”

As regards measurement in the financial statements, most respondents (74 percent) are satisfied with the status quo (that is, historical cost less depreciation and impairment).

There is very little appetite in the primary statements for a measurement basis other than amortised historical cost. However, disclosure is another matter, with 52 percent seeking information about replacement cost and 37 percent favouring a sales price or similar measure of exit price. As one might expect, most (70 percent) of those favouring sales price are fixed income analysts who are generally more concerned about debt coverage and potential break-up values.

There is also an appetite for greater disclosure around capital expenditures, which is consistent with the cash flow objective described above.

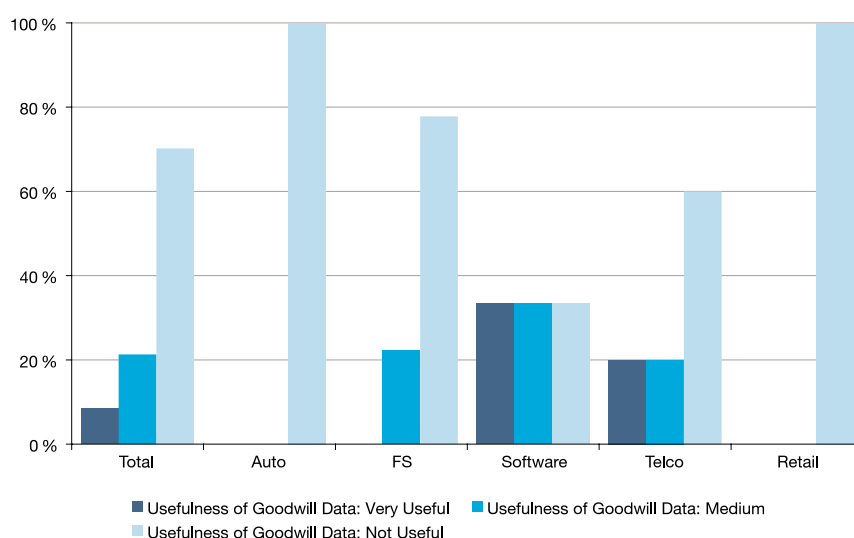
Goodwill

Most respondents do not consider goodwill balances in their analyses. In our sample, 70 percent describe goodwill as “not useful”.

Where any use is made of goodwill, it is considered helpful in assessing the success of past acquisitions.

With so little interest in the goodwill number, respondents are ambivalent about its measurement. Only 38 percent express an opinion and most of those favour measurement at historical cost less impairment.

Figure 3: How useful is goodwill data?



Other intangibles

Many of the respondents view intangible assets much as they view goodwill, with 74 percent describing the item as “not useful”.

Participants are interested in the nature and amount of a company’s intangible assets. However, the interviewees are not interested

in recognising such amounts in the balance sheet.

Some strong views were expressed about research and development and the requirement to capitalise development expenditure either after certain criteria are satisfied or when it is acquired in a business combination. Many respondents describe as confusing the current

model whereby some expenditure is capitalised and some expensed.

Concern was also expressed about the reliability of data related to intangible assets.

It is hard to draw firm conclusions from this result, although there is clear evidence that respondents are more interested in the nature of and expenditure on intangible assets than in the treatment of intangible assets in the primary statements.

Figure 4: How useful is data about other intangibles?

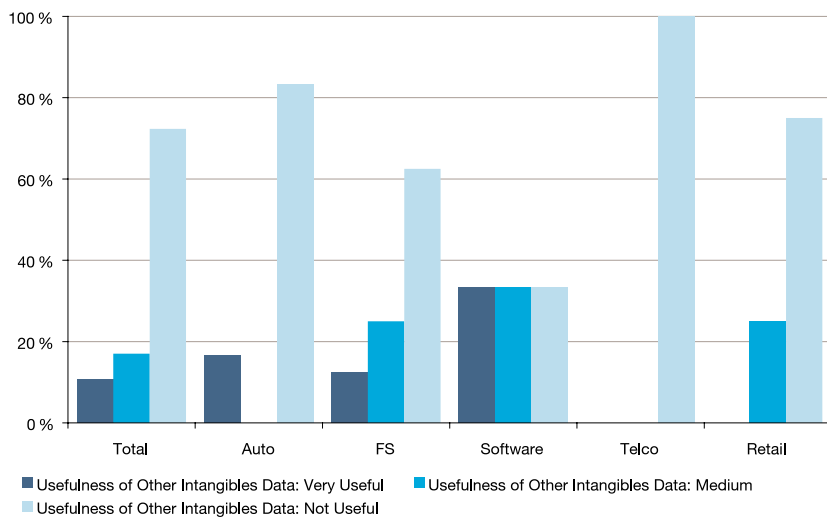
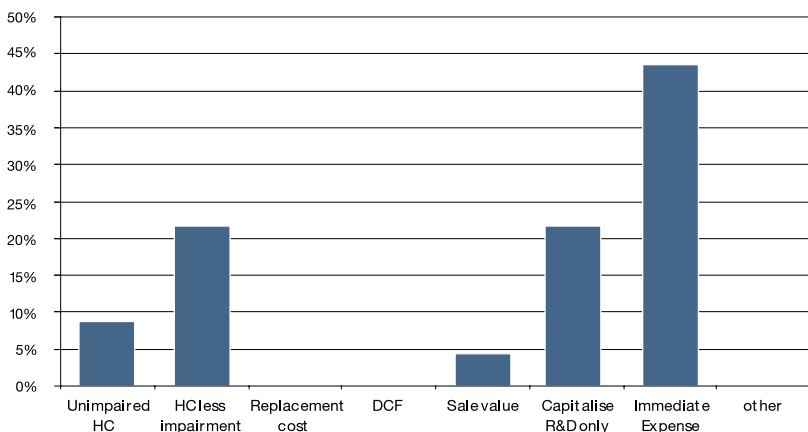


Figure 5: How should other intangibles be reflected into primaries?



“Separating goodwill into different components is a complete waste of time.”

“These things are incredibly hard to value. If you look at most businesses, much of the value is actually in the intangibles. But valuing them is impossible.”

Review of Findings

Working capital

Overall, 55 percent of respondents consider working capital to be “very useful”, whereas 28 percent consider it to be “not useful”. However, the industry analysis indicates that the usefulness of information about working capital varies from industry to industry. For example, all respondents from the retail sector consider working capital to be “very useful” while 100 percent of respondents from the financial services sector consider it “not useful”.

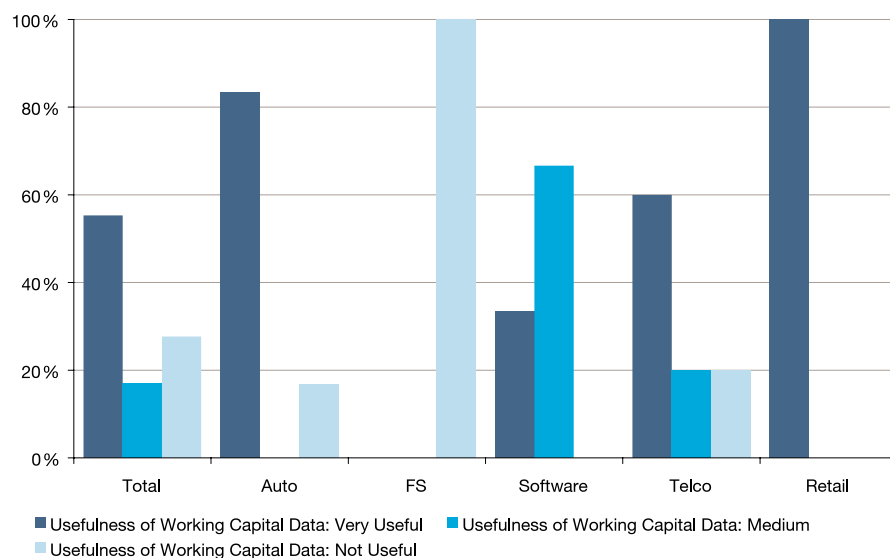
The financial services sector seems to be the outlier; in all other sectors, working capital can at least be described as more useful than not. This result could reflect the fact that the concept of working capital has less meaning in the financial sector.

Where working capital information is considered useful, it provides input to cash flow models (51 percent) or gives evidence of business trends (42 percent). Only a handful of respondents use working capital information in any other way.

Equity analysts use working capital information in a variety of ways, but fixed income respondents participating in the survey all use working capital data as an input to a cash flow model.

A small number (10 percent) of respondents, scattered across industry sectors, consider that working capital should be measured on a current value measure. The remainder favour a version of historical cost.

Figure 6: How useful is working capital data?



Provisions

Provisions* are considered to be a “very useful” source of information by 51 percent of our respondents and “not useful” by 28 percent. There is no significant variation by industry sector.

Where provisions are considered useful, the majority (86 percent) use the information as an input to a cash flow model. This is not surprising because provisions and the related disclosures can give an important insight into the sensitivity of future cash flow projections.

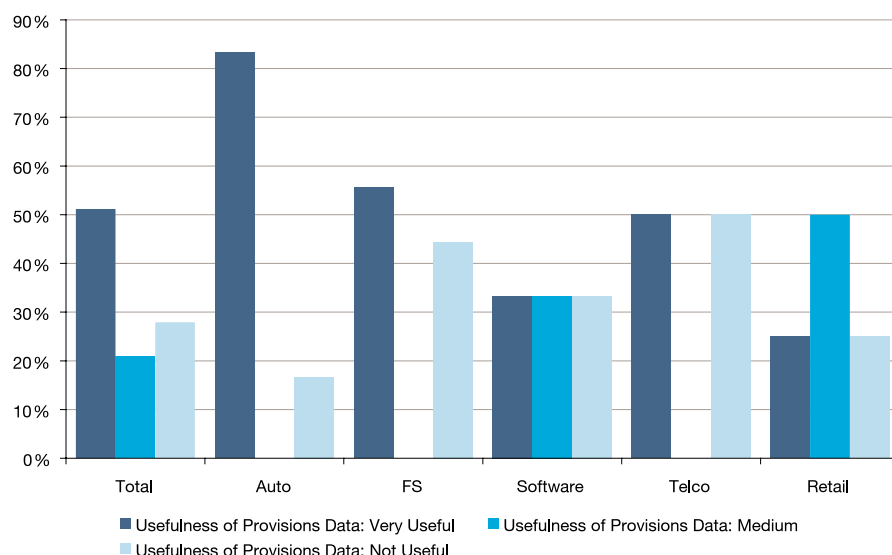
Most of the respondents (86 percent) support the current model whereby a liability is only recognised when an outflow is likely.

Regarding the measurement of provisions, almost all respondents (96 percent) prefer a model based on probability-adjusted discounted cash flows. There is little support for the current proposal that non-financial liabilities be measured at current value regardless of whether the event is deemed probable. However, there is significant support for greater disclosure, which might include a probability-adjusted discounted cash flow analysis without the recognition hurdle, or some other current value measure.

One particular type of provision that causes much concern is the accounting for defined-benefit pension plans.

“Smoothing mechanisms make pension accounting completely impenetrable for most people.”

Figure 7: How useful is provisions data?



* for the definition of ‘provisions’, please refer to page 7

Review of Findings

“If I really want to know the market value of the debt, it’s on Bloomberg.”

“I don’t need you to put the market value of debt on the balance sheet.”

Debt

Debt information is almost universally (74 percent) considered to be “very useful” except in the financial services sector, where 56 percent of respondents consider debt to be “not useful”.

The debt balance satisfies a number of information objectives, as shown in Figure 9 below.

In almost all cases (86 percent), the measurement basis preferred by respondents is the settlement amount rather than a current value. Nevertheless, many respondents acknowledge that the current value of debt is an important measure for calculating enterprise value. However, they prefer to develop their own measures.

Figure 8: How useful is debt data?

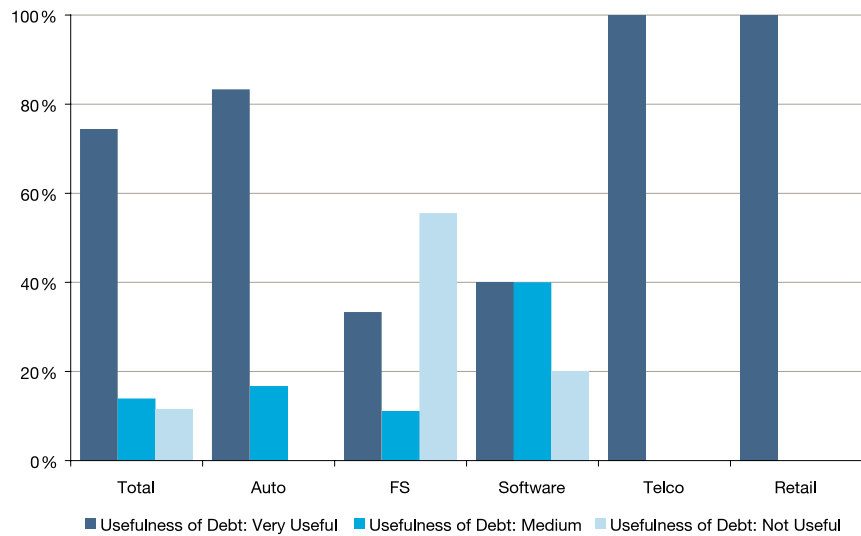
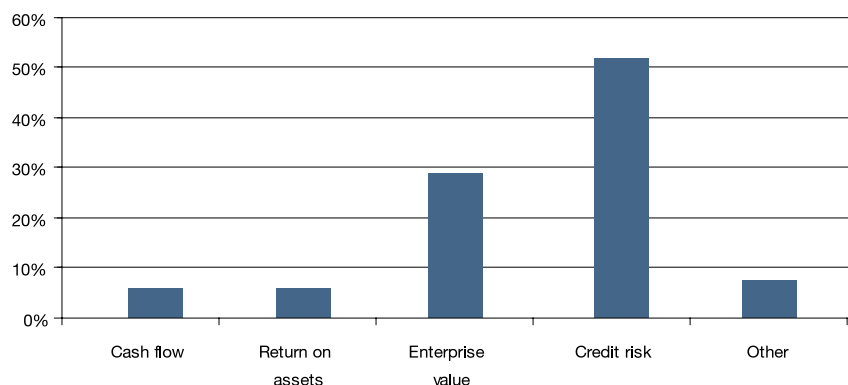


Figure 9: How is debt data useful?



Taxation

While taxation was not a survey topic, a number of respondents raised concerns about the current accounting model. Accounting for deferred taxation, in particular, was frequently cited as an area where disclosures could be improved.

“Somebody has to figure out a way to make deferred tax more understandable.”

“For things like deferred tax assets or liabilities, we tend just to say to ourselves, we really don't know what's going on here.”



Addendum:

Keeping Abreast of Accounting Developments

Few of the investment professionals we interviewed describe themselves as “engaged in the standard-setting or regulatory process”. This observation, based on surveys conducted by PwC firms in the US and Canada in 2006, was reinforced by the interviews conducted in this survey.

PwC is committed to facilitating greater engagement by all stakeholders in the financial reporting process. We encourage investment professionals to offer comments on the due process documents that will be published by the FASB and IASB in the coming years or indeed to participate in the standard setters’ established user groups.

We recognise that, owing to time constraints, some investors may not be able to engage with the standard setters directly on all of the standard-setting activities. Therefore, we commit to canvass opinion on critical topics.

Participants might also wish to consider joining the debates that are proving their value in investor forums such as the Corporate Reporting Users’ Forum (www.cruf.com).

Key dates for some of the more significant IASB/FASB projects are set out below:

An up-to-date project timetable can be found at www.IASB.org or www.FASB.org.

Topic	Document	Standard Setter	Publication date
Fair value measurements *	Discussion Paper	IASB	Q4 2006
Income taxes	Exposure Draft	IASB	Q1 2007
Valuation standards for financial reporting *	Invitation to Comment	FASB	Q1 2007
Consolidations	Discussion Paper	Joint	Q2 2007
Financial statement presentation *	Discussion Paper	Joint	Q2 2007
Post-retirement benefits	Discussion Paper	Joint	Q3 2007
Business combinations *	Standard	Joint	Q3 2007
Revenues	Discussion Paper	Joint	Q4 2007
Leases	Discussion Paper	Joint	H2 2008
Phase 2 of the fair value option project *	Discussion Paper	FASB	TBD

* These projects will have a material impact on measurement and the presentation of remeasurement gains and losses

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