

# FINANCIAL REPORTING: AN INTERNET CLEARINGHOUSE

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Abstract: The creation of accounting transactions has been changed from a manual to computerized recording. In many operational applications the accounting entries are generated as a byproduct of the underlying transactions (such as sales), thus making it possible to shorten the existing delays in creation of accounting data. Under this method it is possible to issue financial statements monthly or weekly, as opposed to the presently used quarterly and annual periods. Many corporations already generate such financial reports for their internal use, but not for external purposes. Corporations provide the Security and Exchange Commission (SEC) with more detailed and supplemental information, in addition to the financial reporting, including sales of their stocks by their officers. Corporations also disclose substantial facts in their press releases and conferences with financial analysts. They are obligated to disclose this information to their shareholders. But how to do it quickly and in a way that small investor could obtain this information at the same time as the institutional investors? It would be advisable to distribute financial reports via an electronic clearinghouse. This method would permit an instant access to the reports and assure that these documents cannot be modified. In the following paragraphs we will review the existing reporting frequency contrasting them with the needs of investors, and describe the generation of accounting transactions. Next, the proposed method of collection and distribution of financial reports as well as their possible analyses by a central electronic clearinghouse will be discussed. Finally, we will explore the need for changes of the attestation standards, describe how to assure the integrity of distributed electronically financial statements, and propose sequence of implementation of the new distribution.

## 1 EXISTING REPORTING FREQUENCY VS. INVESTORS NEEDS

During the last decades we experienced great improvements in the areas of data communication and telecommunication. News about events around the world are delivered almost instantly. Similarly, financial news are distributed with minimal delays. With the fast growth of the securities trade there is a growing need for fast and reliable financial information.

The basic reliable source of financial information is presently provided by the financial reports. Corporations listed on American exchanges are obligated to provide all its shareholders and potential investors with annual audited and quarterly un-audited (but reviewed by auditors) reports. In many European and Asian countries listed companies are required to

provide only semiannual and annual reports.

Markets usually respond very quickly to the results presented on financial reports. And so, a report with a lower than expected earnings of few technology companies in the year 1995 and 2000 resulted in a dramatic drop of stock prices of the entire technology industry. Although more frequent reporting would not prevent the recent accounting frauds committed by several corporations, but it could potentially speed up the discovery of the problems since it is more difficult to manipulate reports a dozen times a year than four times.

The existing frequency of reporting was established in the pre-computer era. One may assume that such reporting periods were the most feasible frequencies at a time of manual time-consuming preparation of reports.

Today's investors must wait until the end of a quarter to learn about financial results, or for an occasional release of earlier estimates of corporate earnings. Such information is immediately absorbed

by the markets, resulting very often in significant changes of security prices. It becomes clear that institutional and individual investors would like to make use of more frequently released financial information. Such information would be most beneficial for individual shareholders since mutual funds and investment houses often obtain information directly from corporations between the reporting periods. Actually, the annual financial reports are delayed more than a quarter from the end of the annual accounting period. It takes several weeks to proof and print these reports, then distribute them by mail. Most of annual financial reports reach the investors in the month of March of the next year.

In the summer of 1996 the American Security and Exchange Commission (SEC) adopted a rule permitting the use of the electronic media delivery in compliance with the information delivery requirements of the federal securities law. The term "electronic delivery" refers to transmission of information via facsimile, CD-ROM, electronic mail, electronic bulletin boards, Internet, or computer networks. SEC also issued interpretive guidance on the use of electronic media by broker-dealers, transfer agents, and investment advisors for the delivery of information to their customers.

In the year 2000 SEC issued regulation requiring listed companies to make their financial releases available to shareholders at the same time as they become available to investors.

In the following paragraphs we will try to argue that it is possible to greatly increase the frequency of financial reporting without a significant increase in the preparation effort. Also, a method for the electronic delivery of financial information will be discussed.

## 2 POSSIBILITY OF PAPERLESS ACCOUNTING

In the early stages of the computerized era it was easy to be convinced that we are approaching the so called "paperless society," where the use of the paper for the commerce would be greatly reduced. Ironically, computers, with their vast ability of printing reports and documents, increased the paper usage. It is assumed that paper usage will grow at least until the end of this decade (Rifkin, 1995, p. 450).

What are the reasons for such an increase in paper usage despite the fast growing computerization? Essentially, paper is preferred by readers. Reading from a computer screen is not convenient. Paper is accessible and easy to read. Only during the last few years has significant progress had been made in transferring documents electronically within a company on the organization's network, usually local

area networks (LAN) and between companies and individuals on wide area networks, mainly via INTERNET. Still, these links for retrieval and transmission of documents are awkward to use and require technical skills. Since security issues are still plaguing computerized networks, the users are reluctant to make themselves dependent on computerized documents. At the same time the printing of computerized data in a high resolution and even color hard copy is getting easier and cheaper. The largest maker of printers "Hewlett Packard is shipping monthly almost 1 million laser and ink-jet printers" (Rifkin, 1995 p. 47).

Despite this paper glut the base for electronic transactions is being expanded. Banks and software companies are introducing the second time around, easier systems for electronic banking. The proliferation of PC's and increased ease of use of INTERNET has drawn over 100 million estimated users, as of year 2000.

The internal electronic mail system is used by virtually all large companies and institutions. The document imaging technology, which converts paper documents into digital form, makes significant inroads into insurance, banking, and other paper intensive industries. And for years some operations, such as electronic money transfers, have been for the most part "paperless." Another application that could operate in a similar manner, without paper is financial reporting.

Several large corporations, such as General Motors or Microsoft, post their financial statements on their Web sites. Although this information may be helpful to investors, the usage of such sites may be cumbersome to investors since each site is organized in a different fashion making the search time consuming. Furthermore, such sites may post only financial statements and skip the supplemental information, such as the SEC filings. A shareholder having twenty stocks will have to access twenty sites, sometimes several times if the reports were not released yet.

The clearinghouse would have a send emails informing registered shareholders that their companies reports were posted or just email the financial reports and the supplemental information. This way every shareholder, small or large, will have an equal opportunity to review financial reports as soon as they are released.

## 3 PROPOSED METHOD FOR DISTRIBUTION OF FINANCIAL REPORTS

Accounting is a prevalent computerized application in

all industries. Frequently paper is being used as the source for its input and almost always as its output. Such manufacturing companies as the SATURN car factory, a division of General Motors, started to eliminate paper documents in dealing with their suppliers. SATURN transfers supply requests via computers, paying suppliers for material based on the number of finished cars. Although most companies are still lacking a "paperless" electronic link to outside commercial partners their internal flow of accounting data is usually performed on an electronic media, either via tapes/disk or increasingly via INTERNET or network transfer.

Table 1- Web Based Financial Reporting Using Clearinghouse illustrates this method. Under this approach operational applications such as Sales or Manufacturing generate, as a byproduct of their basic operational functions, the resulting accounting journal entries, which, in turn, are fed into the general ledger system. It is feasible to create weekly or monthly financial statements from such an almost updated ledger (short of some additional entries) and submit them electronically to a clearinghouse. Shareholders of a corporation and other investors would have a prompt access to these reports and financial ratios on an as-needed basis to facilitate the investment decisions. Obviously, proper method to assure accuracy and integrity of data must be in place.

For several companies, such as Bankers Trust of New York, the creation of accounting data is a required part of their technological architecture of each application. Therefore, general ledgers are customarily updated on a daily or weekly basis via

magnetic media. An example of Motorola, a \$22 billion company with six operating sectors, which does its monthly books within 2 days, proves that the preparation of frequent financial statements is an achievable task (Zarowin, 1995, pp. 59-62).

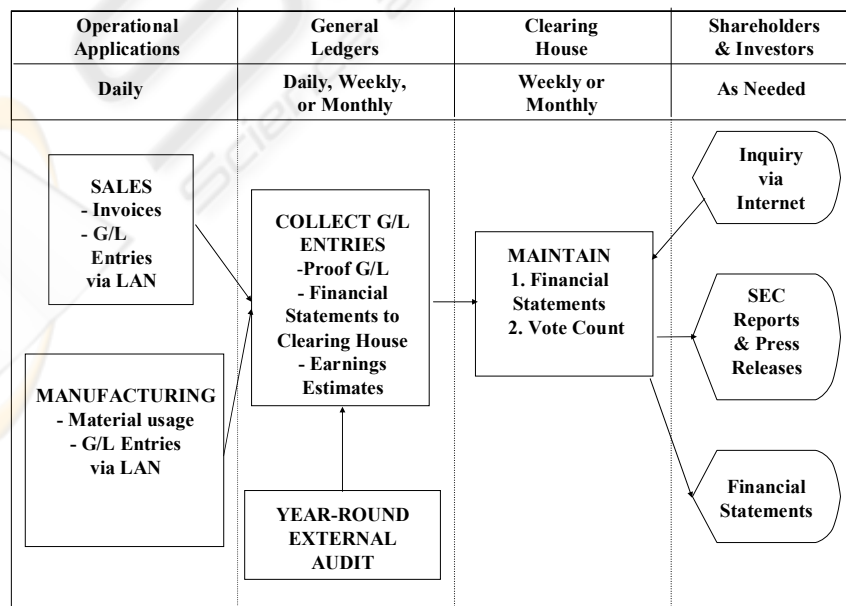
The existing frequency of report issuance (annually for audited reports and quarterly for the un-audited ones) was established in the pre-computer era. Corporations are now operationally able to prepare monthly or weekly reports and to issue them with much shorter delays than it is done presently. Part of the delays is due to the usage of a printer services preparing glossy reports, attractive to read, but taking long time to validate and print. And with today's color printers and graphical capabilities investors may receive quite esthetically pleasing reports via internet.

Investors, both institutional and individual, would benefit from having these reports on a monthly or weekly basis. For this frequency change to occur one or few clearinghouses should be established in order to collect and reports from corporations via INTERNET.

Markets respond quickly to the reported news about earnings and earning projections of companies. Presently, such information is known mostly to some financial analysts and institutional investors, thus depriving individual shareholders from usage of this information for their trading decisions.

Information submitted to clearinghouses on a predetermined period basis should be accessible to all interested parties. The files should be protected from alteration. No addition or modification should be permitted, to assure the data integrity.

Table 1: Web Based Financial Reporting Using Clearinghouse



Each shareholder would be in a position to retrieve the financial reports on his/her computer as soon as they become available at the clearinghouse or have it automatically emailed to his computer. Shareholders should still have an option of receiving paper printed statements, incurring the delays associated with their printing and postal delivery.

#### **4 FINANCIAL RATIOS AND VOTING**

The financial statements should contain comparison of several comparable periods for at least five years. Additionally, ratios comparing a given corporation to other entities within the industry group could be calculated. Such data should be helpful in performing financial analysis, including computation of the popular ratios.

In addition to the financial report the corporations would transmit to the clearinghouse their SEC reports (10K, 10Q and others), their press releases and disclosures made to financial analysts. Although SEC has a site EDGAR which contains SEC filings it is difficult for a shareholder to navigate this site and the data is not arranged in a comparative fashion, which would help in analysis, especially for a small shareholder owning a dozen or two different stocks.

Since financial analysis is presently not required under the existing accounting standards the users do not expect the issuer of the statements to perform financial analysis of its own results. However, it would be advisable to request the clearing house to compute the popular financial ratios and indicators, without any commentary or recommendations regarding these results. This way an individual shareholder would have access to analysis available to institutional investors employing its own analysts.

The voting for the board of directors by all shareholders is done via mail. It could be done via Internet, assuming adequate security. Several corporations are already offering such an option, but again, having a standardized and secure procedure in one place would be welcomed by shareholders and it could even increase the voters' participation.

#### **5 XBRL- THE NEW LANGUAGE OF ACCOUNTING AND FINANCE**

Users of accounting and financial information encounter many difficulties in transmission,

reporting, quantitative analysis, and rewrites of accounting data. To relieve these problems the American Institute of Certified Public Accountants (AICPA), Reuters, and thirty other organizations created in year 2000 a task force to create a special version of a widely used language for Web sites called the Extensible Markup Language-XML.

This accounting oriented new language, named Extensible Business Reporting Language-XBRL, uses data tags or markers to define and describe data elements comprising financial statements. These markers, always attached to the data elements, permit users to utilize all data elements for variety of reports and calculations, regardless of the temporary position of such elements due to sorting or processing of data. Imagine an eagle with an implanted chip, which may always be identified, even if he moved to another location. Every language and software program, such as Java, spreadsheet, or data base language could identify a particular data element, such as a depreciation amount, based on the embedded marker. XBRL is still undergoing changes and improvements, but several companies and institutions are experimenting with the new language.

Furthermore, XBRL utilizes templates that recognize the internal structure of financial statements, helping in the creation and quantitative analysis of such reports. Having the markers and templates we will recognize a given amount, let's say depreciation, as a sale or administrative expense and also link it to the accumulated depreciation on the balance sheet. For users and preparers of financial reports it will be relatively easy to utilize such marked data for analysis, computation, reporting, and comparison with prior periods or other companies.

It could be beneficial if the data in the clearing house is stored in the XBRL format, making it easier to utilize the data by different programs on different operating system platforms. XBRL is not limited to American users, but it is intended for use internationally. This way, it may also help by making the data of different countries more understandable to foreign users.

#### **6 COST AND SECURITY ISSUES ASSOCIATED WITH REPORT DISTRIBUTION**

The electronic distribution cost would probably not

exceed the recent expenses of printing and distribution of paper reports. Most probably, it would result in significant savings. The cost associated with electronic reporting should be absorbed by the issuers of financial statements.

In addition to distribution of financial reports, the clearing house should distribute also the ad-hoc company press releases to make them available to all users at once, as required by the new SEC regulations. The clearing house may also collect shareholder votes in board of directors elections, saving again on the mailing of proxy and the count of votes.

To make it easier for shareholders, every clearinghouse, assuming there will be a few of them, will have automatically transfer reports of any corporation, even if it is posted on a different clearinghouse. This way no shareholder will be required to access more than one clearinghouse in order to get all his reports.

The clearing house would have to undergo periodic audits by a regulatory agency such as SEC, to insure that its operations satisfy the requirements for data integrity and secure accessibility.

## 7 NEW ATTESTATION STANDARDS

Since corporations are not required presently to issue monthly or weekly statements, the auditing standards would probably have to be modified to take into account the new frequency and delivery methods. Issuers of financial statements would have to make more frequent adjusting entries, such as depreciation. However, these adjustments will not constitute a great hardship to the preparers since extracting this information from the existing computerized databases is easy.

The existing auditing methods would have to be modified, to provide for the attestation of issued statements. However, many auditing firms already perform "constant" audits of a company's results by examining its computerized records. In fact, some auditors have an on-line access to the computerized records of the audited company.

Most probably a new type of attestation opinion would have to be established for these frequent reports.

## 8 PROPOSED STEPS FOR IMPLEMENTATION

The discussed above changes require time and careful planning for their implementation. The initial steps, foreseen for the change, are as follows:

- Issuance of standards for the new reporting frequency and attestation could take affect within two years, so the issuers would have sufficient time for implementation of the change.

- Execution of a pilot program for companies that will elect to comply with the new requirements before the due date.

- Selection of several clearing houses to provide the distribution services. Each of the selected clearing houses will be obligated to transfer information about any corporation even if it is stored on another site. This process will transparent to the shareholders.

- After initial test phase all corporations will have an obligation to submit their data to a clearinghouse.

- Each shareholder will have an option to receive the data about the corporation that he/she owes shares in a selected way. Shareholder will specify the desired delivery method: email, Internet access on demand, or hard copy reports.

## 9 CONCLUSIONS

In conclusion, it is reasonable to assume that it would be both possible and beneficial, especially for individual investors, to receive more frequent, electronically distributed financial statements. The new technology makes such an operation possible, most probably without any increase in the costs of delivery to the provider or user. Although some companies already offer such an option to their shareholders, these services would be more reliable and much easier to use if an independent and a well secured clearinghouse would be responsible for the distribution of all financial reports.

Also, it would be much simpler for an investor holding several stocks obtain information about all of his companies from one source in a uniform manner, common to all companies. The clearinghouse would be in a good position to ascertain that all reports are provided in the XBRL format, enabling users to prepare their own reports and analytical ratios, if so desired.

Shareholders would have to deal with only one source for electronic voting for their boards and have an instant access to companies' press releases.

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