Introduction

After Enron, few people would question the need to re-examine the quality and rigour of financial reporting. It may be true that, thanks to Sir David Tweedie’s efforts at the helm of the Accounting Standards Board (ASB), UK GAAP rules would have made it difficult for Enron to transfer debt off its balance sheet by using a network of affiliates. However, the recent report from the Treasury Select Committee warned that it would be ‘dangerously complacent’ to assume that this type of failure is inherently less likely to happen here. Obscure reporting practices have been bringing down share prices. The belief in the soundness of financial reporting has taken a knock.

The biggest driver for transparency used to be the European companies’ push to access the US capital markets and the desire to be seen as progressive. However, in the wake of the recent accounting scandals, investors are becoming hypersensitive to the reliability of published accounts and suspicious of the possibility of inflated earnings. The slightest hint of wrongdoing now has the potential to deflate investor confidence and bring share prices down.

In other words, the drive has become more urgent and more desperate as the investors – fearing another case of ‘enronitis’ – steer clear of companies with opaque business reporting systems. Transparency is becoming a matter of survival rather than choice and people are beginning to remember that the rules of financial reporting have never been an exact science immune from interpretation or indeed human error.

When Enron failed to make new deals, it allegedly changed the valuation assumptions that determined current-day recognition in financial statements. In this way, it was able to report profits despite the rising debt – and what it did still has to be proved illegal. Companies such as IBM have started providing additional financial information in the light of concerns about the reliability and comprehensiveness of its figures – for example, its rival, Siebel Systems, accused IBM of peddling ‘accounting fiction’. GE has also been under pressure to modify its reporting practices. In its annual report published in 2002, it boasted that the financial results section was some 30 per cent bigger than before yet it still came under criticism for failing to provide its investors with adequate information. Of course, better disclosure does not necessarily mean more disclosure, particularly given the pressure on investors’ time.
So what should companies do to achieve better disclosure? The aim of this briefing is to provide the broad outlines of the problem and suggest some possible ways of moving forward. We hope to sketch out some ideas about what constitutes best practice. The primary aim, however, is an awareness-raising exercise, as the only way corporate reporting is going to move forward is through a deeper understanding of the issue and a commitment to improvement by everyone involved.

In that sense, this is a guide for anyone concerned about what their companies should be doing. Some of what is said in this briefing can be found elsewhere but the aim here is to bring the diverse strands of the transparency agenda together in one place. In any case, we make no apology for repetition – despite the professional bodies' interest and the various books and articles published in the last few years, corporate failures – of which Enron is a spectacular example – continue to happen.

Chief executive officers, finance directors and auditors should start to understand that this issue does not just affect their individual operations but capital markets as a whole. If the confidence in markets is missing, capital to finance day-to-day business and longer-term investment funds will be less forthcoming and more expensive as higher rates of return and greater security are sought to offset the perceived risks involved. And that confidence will depend on the quality of reporting by listed companies.

The proposed mandatory Operating and Financial Review – which will require directors to give a qualitative as well as a financial evaluation of performance – should go some way in broadening the scope of business reporting. But there still needs to be an extensive programme of education of everyone involved in order to change perceptions and engender a wider cultural change.

So what is wrong with the reporting framework? Put bluntly, the current system of business reporting cannot meet all the needs of the modern economy. There is a whole host of inter-related factors that expose its shortcomings.

Reasons for change

First, it is geared towards the production of historical information. In the current environment, particularly in those sectors characterised by extreme market volatility, it offers little basis on which to predict the future performance of companies. Accounting is accepted as a way of verifying history. Considering the future is never the same as the present, this offers little support for valuing companies beyond basic extrapolation. Historical performance is not a reliable predictor of a company’s future. In addition, as technology continues to lower the barriers to new firms entering markets (as well as creating new markets altogether), many of the companies the markets have to value will have no history to speak of in any case.

Second, the system takes no account of the major intangible value drivers in companies. This has the most pronounced effect on knowledge-intensive companies where intellectual capital makes up most of their market value. But the consequences are universal – all companies have knowledge, experience, customer relationships and so on (expressed as brands, goodwill or competencies) that are currently unaccounted for.

(See CIMA Technical Briefing Managing the Intellectual Capital within Today’s Knowledge-based Organisations for further information.)

The system is geared towards reporting only one dimension of value – the financial one. This inevitably means that a whole host of other factors that contribute to a company’s performance do not get communicated through the public channels. A recent CIMA research report by John Holland showed how fund managers use private meetings with a company’s managers to obtain information on:

… qualitative, non-financial company variables such as ‘quality of management’, strategy and its coherence, investment and financing plans, recent changes in these and in corporate succession and management style. Information on competitors and the structure of the competition was also very important. (Holland, 2002)

Admittedly, even with increased disclosure, fund managers would still be likely to favour private meetings in order to probe a company’s strategy in depth, to ‘look into the whites of the eyes’ of managers, as Holland says. The main reason for the continuing importance of such meetings is that they provide a unique opportunity for analysts to assess the strength of a company’s management and leadership.
It is interesting to note that, within the UK, there seems to be a consensus that high-quality management and leadership skills are in short supply. In a summary report by the Council for Excellence in Management and Leadership (CEML), appointed by the Secretaries of State for Education and Employment and for Trade and Industry, one of the recommendations is to develop mechanisms to track progress in the UK’s management and leadership capability.

The report in fact acknowledges the paucity of information – which, as Holland shows, has to be supplemented from other sources – and recommends voluntary corporate reporting of management and leadership capability for public and private sector organisations promoted through appropriate professional bodies. They acknowledge that this ‘could become an element within a wider proposal for human capital accounting and reporting’.

In a report commissioned by CEML, the authors from the Cranfield School of Management argue that more formal reporting in the field of management and leadership is not only desirable but is in fact inevitable. However, their view is that a standardised reporting framework is not the way forward as the choice of measures used by companies is context- and strategy-specific. Instead, they propose a ‘toolkit’ consisting of a standardised set of generic questions that organisations can be expected to address in their annual reports. The potential measures suggested are grouped together under the following headings:

- morale;
- motivation;
- investment;
- long-term development;
- external perception.

Further details can be found at: www.managementandleadershipcouncil.org

CIMA believes that corporate reporting should provide users with more forward-looking information about intangible assets and other drivers of shareholder value. At present, such matters are covered by limited statutory requirements relating to the directors’ report and by non-mandatory ASB guidance published in 1993 on the operating and financial reviews (OFRs) of listed companies.

The drive for transparency will inevitably have an effect on the board of directors, especially the audit committee. The audit committee exists to look after the company’s financial wellbeing and this should include overseeing the quality of information released to external stakeholders.

An article in the Financial Times (10 June 2002) claimed that the role of audit committees as it is currently defined is too narrow and too technical to achieve this. It goes as far as calling for them to be renamed ‘transparency committees’, in charge of ‘assessing the effectiveness and disclosure of the company’s main performance indicators’. This would mean that they are in charge of monitoring both the statutory reports as well as the investor relations strategy. It is too early to say whether the change will be as far-reaching as that but there is no doubt that Enron has provoked a whole-scale investigation of what constitutes good corporate governance.

Judging by their reporting practices, companies appear more worried about ‘the cosmetics of value streams’ than long-term value generation. The metrics used to report performance continue to be largely financial ones such as earnings per share (EPS), even in companies evangelical about stakeholder management.

In fact, part of the reason for Enron’s spectacular downfall has been its insistence that it was ‘laser focused’ on EPS. As a number, EPS is relatively easy to manipulate. Struggling to meet their quarterly targets and City expectations means that managers often make short-term decisions that can lead to destruction of shareholder value. When asked if this is true, most managers deny that they would ever behave in this manner but – unsurprisingly – think that managers of other companies do so (Eccles and Mavrinac, 1995).

As far back as 1995, Eccles and Mavrinac reported on the shortcomings of capital markets. Their survey of corporate managers, financial analysts, portfolio managers and investors found that 87 per cent of all respondents agreed that the markets are short-term oriented. In the last seven years, things could have only got worse due to, for example, the proliferation of knowledge-intensive companies with long-term R&D projects.

The current system has also become increasingly complicated. All this creates a gap between what the equity investors and analysts need and what the companies provide – and how they provide it. Put simply, the result of all these inefficiencies is that markets are not getting the information they need. Instead, rumours and gossip proliferate.

Take Enron again – part of the reason why such a huge and seemingly profitable company collapsed in what seems like such a short period of time is partly due to the fact that few people apparently understood exactly what it did. Its accounting practices and its network of partnerships were so complicated that the ‘black hole’ in its accounts was spotted far too late by the outside world. Of course, one also has to question the diligence and independence of the analysts and stockbrokers involved.

Transparency

The way to address at least some of the inefficiencies mentioned above is to advocate more transparency in financial reporting. This essentially means that companies would start providing all the information the market considers relevant rather than simply fulfilling their mandatory regulatory requirements.
Transparency in this context means that there should be little difference between the performance measures used internally and those reported to external stakeholders – essentially, what is measured internally and reported externally should be the main value drivers of the company. At the moment, management accountants may use one set of measures that gets converted into another set when reported externally. Instead, they would have to develop internal control systems closely aligned with the strategic direction of the company and forge much closer links with finance professionals in charge of both reporting and auditing.

However, achieving total transparency is far from easy, and some of the problems associated with it will be discussed later in this briefing.

More reasons for change

The paucity of relevant information can result in all sorts of anomalous behaviour. For example, ‘ordinary’ investors currently lack sufficient information upon which to judge a company’s current or future performance. It follows that insiders – with access to privileged or exclusive information, including unreported intangible value drivers – could be in a much better position to invest and trade in a company’s shares.

As already mentioned, this vacuum created by the lack of relevant information soon gets filled with gossip and rumours that can generate market volatility. It can harm companies more than it can help them – it is more likely to distort performance downwards than it is to overvalue it. The purpose of financial statements was to provide useable and comparable information to external financial stakeholders. This function should not be superseded by insinuations and gossip that favour insider trading or speculation.

In fact, various research projects have shown that managers believe their companies are on the whole undervalued (with the lucky few thinking they are overvalued!). Apart from the obvious company bias, the other likely reason for this is that the information that managers use internally is not the same as that reported externally.

Why do companies continue to play accounting games?

What is the motivation behind such behaviour? Why would managers deliberately provide less information than is needed for their company to be valued accurately? Why do they continue to play accounting games, despite the potentially disastrous consequences? The answer has as much to do with behavioural and cultural issues as it does with hard metrics. After the Enron collapse, it was said that its aggressive culture led to aggressive accounting. It was the arrogance that led its managers and Board to believe they could get away with it and that no one would notice the hidden losses.

But it is also about expectations on both sides and the behaviour resulting from those expectations. The comments one hears now are that sell-side analysts working in corporate banks may end up compromising their position through fear of alienating clients who bring in the money. Auditors may earn much more from consulting than they do from auditing. Non-executive directors can suffer from a conflict of interest or a lack of time through too many directorships and are not sufficiently accountable for inadequate reporting. Fear of losing the large fees involved may also reduce their willingness to challenge management’s presentation of results. Managers’ motivation is manifold – most frequently, it is cited as being pure greed – they expect big bonuses that are tied to the company’s share price performance. Admittedly, this only applies to senior managers – ambition is probably the biggest motivator and, at junior level, fear undoubtedly plays a part. Managers are also driven by personal pride on the one hand and a sense of responsibility for the employees on the other. Many of the profit-earning and save-as-you-earn schemes aimed at employees are tied in with the company’s market performance. But, knowingly or not, everyone can be involved in massaging figures for the market and real accountability is frequently what is missing.

If managers perceive that the market does not value, for example, their long-term investments, they will conduct their business accordingly. Eccles and Mavrinac report that typically this results in three kinds of responses – some managers accept the ‘realities’ of the market and stop investing in long-term projects, some work harder at communicating their strategy and some limit communications with analysts and investors altogether. Clearly, two of these responses can be seen as unsatisfactory.

Part of the reason also lies in the way that companies structure their reward policies. A research report by CIMA (Cooper et al., 2001) found that, in most companies investigated, the basis for determining rewards is the effect of performance upon the share price. Interestingly, this was the case in most companies, regardless of their performance philosophy. In other words, even those companies that are explicitly dedicated to a stakeholder approach tend to focus primarily on measures such as EPS.

Rewarding performance solely on the basis of meeting the short-term earnings targets inevitably pushes the managers into short-term decision-making. By the time the value of a long-term investment is realised, the executive is probably no longer with the company. Their time at the top is limited so they quite naturally strive for immediate, short-term impacts. Companies are becoming increasingly aware of this and more and more are offering long-term incentive plans as a way of providing a balance. However,
with the average executive contract in the FTSE 100 being no more than a year (Financial Times, 20 April 2002) and an average tenure only four (Guardian, 5 September 2001), it is hard to see an immediate change.

For anything to be different, the whole culture of capital markets will have to change. CIMA research (Cooper et al., 2001) has shown that there are usually three main reasons why companies choose to stick with the tried and tested accounting measures of performance. Firstly, it is because they consider the techniques to be perfectly adequate, especially when tied in with the development of other internal measures such as the balanced scorecard. Secondly, the measures used were seen as appropriate for their major stakeholders and sufficient to measure performance accurately. But the companies interviewed also added that City pressure and external expectations were part of the reason they still focus on financial measures of performance. The third reason cited was that they thought the culture of their organisation would not be conducive to a different approach. They believed they would lack the support to adopt and implement any of the new measures. This normally equates with a lack of commitment at the senior level.

Many companies publish more than one EPS figure in an attempt to communicate their results. This allows them to emphasise or de-emphasise particular issues. Ironically, analysts usually convert those EPS figures into normalised earnings, for example, as well as looking for additional ‘soft’ information that will further elucidate a company’s performance. This can only be done properly through an honest stakeholder dialogue and a sea change in reporting practices. If more and more big companies start communicating value to the market in a different, more transparent manner, smaller companies will follow.

It is worth remembering that, although the trend for better disclosure is becoming apparent in large businesses, what happens in the top echelons of the FTSE 100 is no indication of what the rest of the listed companies are practising. Hence the need to raise awareness of the subject among the business community.

As the Enron case highlighted, it is not just the accountants or impersonal market forces that are responsible for corporate failures. The press has singled out the role played by Enron’s auditors and the shredding fiasco. But the role of boards and the issue of corporate governance also deserve closer inspection (see the section on Company Law below). In addition, analysts themselves should come under closer scrutiny – the recent case of Merrill Lynch being asked by the New York State Attorney to disclose more information to investors comes after the company was accused of providing misleading stock recommendations in an attempt to secure contracts for its investment banking services.

It is important to emphasise that the change does not necessarily have to be a regulatory one. It is about the process of disclosure, about how value is communicated to the market. But, if everyone else is already playing the numbers game, what is the advantage of sticking one’s head above the metaphorical parapet? Surely it will not only be costly to gather more information to disclose but companies are potentially risking their commercial sensitivity for little more than a promise of a higher share price? Aren’t you opening yourself up to being taken hostage to fortune, especially when things are going badly? Won’t the markets, being efficient, eventually correct any anomalies without interventions? Isn’t this just a huge gamble that only a few companies can afford?

Post-Enron, the obvious reason for reviewing reporting practices is the danger of crossing the line between earnings management and fraud. There are plenty of opportunities for companies to exploit the inherent scope to exercise judgement when deciding on accounting treatments for a particular transaction, some of which could be labelled aggressive earnings management. There is also an increased feeling of insecurity – managers and employees all over the world are scrutinising their own companies’ accounting practices. This is especially important in times of economic downturn when more managers are tempted to massage the figures in order to inflate their earnings and meet their targets. Boards of directors need to be more accountable for their figures. The problem can only be tackled through the combined efforts of the accounting profession as a whole – regulators, the professional bodies, the reporting businesses and users of accounts such as analysts and institutional investors.

Related to this is the reputational risk that such dubious, albeit legal, practices might carry. If a company’s earnings management tactics are uncovered and publicised, investor confidence will disappear overnight and the share price can go into freefall. We are already beginning to see the same thing happening to companies unwilling to be open with their financial data.

Ironically, in order to limit the exposure to such risk, many companies attempt to restrict or manipulate the amount of information provided. However, the entire information paradigm has changed, mainly thanks to new technology – we expect the information now and, importantly, we expect it for free. If a company fails to provide it, someone else will almost certainly be happy to oblige. It is in a company’s own interest to abandon defensive disclosure strategies and PR gloss in favour of providing timely, relevant and comparable information.

Cynics would say that there is indeed a danger that any additional information provided will be little more than a
public relations exercise. If individual companies are left in charge of choosing what they disclose, the information can suffer from a considerable company bias. Comparing companies would become increasingly difficult as a result, yet the other equally unwelcome extreme is the enforcement of rigid prescriptive rules and a tick-box approach. In fact, comparing like with like is one of the factors in the continuing resiliency of the current system. In the words of Simon London (Financial Times, 16 January), asking a company to put a dollar value on its accumulated research and development spend or any other intangible asset is like ‘asking a kleptomaniac to count diamonds’. Guidelines defining terms such as ‘research and development’ and similar expenditure categories that create long-term value are needed.

In the absence of agreed standards or at least a consensus on the measures used, asking companies to add more detailed information to an already complex reporting system will raise doubts about the comparability and therefore trustworthiness of their published results. In addition, there will be concerns about auditing the information provided in this manner. CIMA has no illusions about how difficult this process will be in practice. Building up data on historical trends is not enough – what the market needs is cross-company comparability. CIMA is currently in the process of initiating research in this area that will contribute to the debate.

New models and standards are emerging all the time – for example, the Financial Accounting Standards Board (FASB) in the USA has announced that it is preparing a new accounting standard that will require companies to disclose information on intangible assets such as brand names, customer lists and patented technology. The exposure draft is expected to be published by this autumn.

The third objection to transparency is usually related to commercial confidentiality. The complaint is, to a certain extent, unjustified – no company will ever be expected to part with truly sensitive information. However, the definition of what may be commercially sensitive has changed. As Nordberg says (Nordberg, 2001), the duration of the value curve has shortened. In today’s volatile markets, the more rapidly market conditions change, the more quickly hard-won market intelligence loses its value. And from the company perspective, the faster the pace of change, the faster the decline in the value of maintaining confidentiality of information.

Benefits of increased transparency

So what are the benefits? For a start, investor confidence will improve with the increase in relevant information. This will in turn lead to more long-term investors. As companies become more open with their strategy, the quality of the management, the value of their assets and the risks they face, they will become a less risky proposition for investors. In this virtuous cycle, they would then have access to cheaper capital. Markets will eventually reward better disclosure and penalise opaque practices. Miller (2001) says:

First, the lack of useful information in a company’s financial statements may cause the markets to pursue other investment opportunities. If so, the resulting diminished demand for its securities creates lower prices and higher capital costs. … Second, the markets may decide that the company’s investment potential is great, even though the reported information is inadequate. If so, they may invest, but only after taking into consideration the resulting higher degree of uncertainty and insisting on a higher expected rate of return which will depress the securities’ prices and increase the cost of capital. Again, this typical minimum reporting strategy doesn’t advance the stakeholders’ interests. Third, sophisticated investors and creditors will turn elsewhere for private information that’s more useful than GAAP financial statements.

Despite all the potential benefits, many are still sceptical about the practicality of total transparency. For many companies, especially the first movers, the shift will not be easy. The biggest obstacle is the fear that the companies could end up being held hostage to fortune. In addition, there will be concerns about the reliability of what the companies disclose. As already mentioned, some kind of external verification and/or auditing will be necessary. The cost of providing more information might prove to be a significant barrier, especially for smaller companies. Some may have already developed leading performance indicators for internal use or they may soon be required to do so by either the general trends in the business world or market pressures. Switching to increased disclosure should be the next step. But starting off with a redesign of management accounting information can prove to be a valuable and cost-effective exercise as it will help companies identify the main assets and activities that really drive value in their companies.

There have been some attempts to develop systems of reporting that would enable companies to address all dimensions of value and report on all the relevant drivers of value generation. For example, Total Value Creation® claims to use ‘methods that measure and report event-based future financial and non-financial value streams’ and assess ‘value creation performance for multiple stakeholders from a variety of perspectives’. Further details can be found at: www.totalvaluecreation.com

Another framework entitled ValueReporting™ has been developed by PricewaterhouseCoopers and is outlined below.
Even before the Enron saga unfolded, companies’ external reporting was already a focus of fierce debate among the accounting community, and of significant ongoing change at the regulatory level. In a post-Enron world the issues are being played out on a wider stage amid the glare of media interest.

The need for a new framework

While we believe that historical financial statements remain a key component of the financial reporting model, we recognise that they do not meet the needs of all a company’s stakeholders in today’s world. With share price valuations increasingly determined by expectations of future cash flows, investors are demanding a better analysis of risk, more forward-looking and non-financial information. These include lead indicators such as customer and employee satisfaction, levels of innovation, through to the impact of environmental issues.

As well as underpinning a company’s performance, these forward-looking factors are pivotal to the creation of value. When a company reports on these in an open and transparent way, it is giving investors and analysts additional information they need to assess its true value. At the same time it is reinforcing the credibility of management. The best-in-class performers have realised they must eventually develop new market-driven reporting frameworks, enabling targeted transparency across the full range of corporate information. And post-Enron, investors will inevitably be focusing – to a greater extent than ever before – on transparency.

The ValueReporting framework

With developments such as these in mind, PricewaterhouseCoopers set out some years ago to develop a market-driven reporting framework specifically to close the gaps between the information companies currently report, and the information the markets want and need. Since then, our extensive research in the capital markets worldwide has enabled us to develop a framework called ValueReporting that we believe provides a comprehensive view of the critical value-relevant information, and how it can be presented in a cohesive and logical way. The research and findings are encapsulated in a book published in 2001, The Value Reporting Revolution: Beyond the Earnings Game.

Put simply, ValueReporting advocates starting from a position of complete transparency, with whatever financial and non-financial information the management uses to run the company becoming the basis of what it reports to the marketplace. Clearly, companies need to make adjustments to deal with sensitive competitive information or unreliable performance measures – but these decisions will depend on the perceived costs and the benefits of making enhanced information available to investors.

Of course, financial information remains very important, and ValueReporting does not replace it. Instead, it looks to augment it in several crucial ways. Investors and other stakeholders want more, and better, information about the factors that effect value creation in a company: market dynamics, corporate strategy and the intangible assets and non-financial measures that are leading indicators of future financial performance. And that information simply does not appear in traditional financial statements.

Research findings

The research that laid the groundwork for ValueReporting is still continuing. Our initial capital markets research, covering institutional investors and sell-side analysts in the USA, the UK and 12 other countries, showed overwhelming consensus on nine measures (out of a total list of 21) considered to be especially important to sound investment decisions:

- Earnings;
- Cash flow;
- Costs;
- Capital expenditure;
- R&D investment;
- Segment performance;
- Statements of strategic goals;
- New product development;
- Market share.

This list includes financial and non-financial information – some relevant to past and near-future performance, other more relevant to longer-term prospects. Both investors and analysts generally reported higher levels of satisfaction with the quality of financial information than non-financial information reported by management.

Our research has subsequently concentrated on specific industries, evaluating the tailored information and metrics specifically important to companies and the market, the quality of this information, how well managers think they are communicating information, and the market’s level of satisfaction with the quality and quantity of information it receives. To date, we have conducted global surveys in banking, insurance,
high technology, consumer products, retail and pharmaceuticals, with several more planned.

This industry-specific research indicates that different reporting models are relevant on a sectoral basis – and even from company to company within the same sector, depending on their strategy and corporate objectives. However, some of the basic findings are consistent across industries, including the view that companies’ corporate disclosure practices are often inadequate – and that there are significant perceived benefits to improving them.

Closing the ‘Value Gap’……

One of our most significant findings is that more and more companies face a ‘Value Gap’ – the difference between management’s perception of their company’s value, and the value placed on its securities in the capital markets. Figure 1 below shows that the executives surveyed tend to see themselves as relatively proactive in how they report to the market. Investors strongly disagreed, however, showing market dissatisfaction with companies’ reporting methods.

![Figure 1: Perceptions of corporate disclosure](image)

However, the potential for narrowing the mismatch between the perceptions of management and investors is underlined by their agreement over which of the performance measures are most important for creating value. As Figure 2 indicates, in every industry both executives and investors placed a greater number of non-traditional measures than traditional financial in their lists of the most important measures.

![Figure 2: The most important measures – executives/investors](image)

…. by closing the communications gaps

The overall message is that the Value Gap is opened up by mismatches between the information that companies report and the information that investors want. Our research has revealed three crucial elements:

- **The Information Gap**
  This is defined as the difference between the importance attached to a measure by analysts and investors, and their satisfaction with the information actually received from companies.

- **The Reporting Gap**
  This gap comes from the management’s perspective, and occurs when management says that although certain information is important in running the business, they fail to make it available to the marketplace. One reason for this could be that the company’s data is not sufficiently reliable to report publicly.

- **The Quality Gap**
  The difference between the importance executives attach to information and the reliability of their internal systems when it comes to generating that information.

ValueReporting in practice:
The ValueReporting Framework

ValueReporting, properly implemented, bridges these three gaps, bringing clear benefits to companies and investors. Companies get increased management credibility; more long-term investors; lower cost of capital; improved access to new capital; and higher share values. For investors, better disclosure provides more relevant information for making sound investment decisions, as well as better risk-adjusted returns.

To help companies put this into practice, we have developed the ValueReporting Framework, an overall approach for measuring and managing corporate performance and structuring communications about that performance (see Figure 3). The Framework is tailored to match the performance dimensions of specific industries, enabling companies to communicate their value in a language that investors will understand.

The Framework is built, above all else, on transparency. It assumes that shareholders come first, while recognising that long-term sustainable value can only be realised if the needs of all stakeholders are also included. Companies should make all information available – unless they have a good reason not to do so.
The Framework addresses four principal categories:

- **Market overview:** the management’s perspective on industry dynamics and market positioning.
- **Value strategy:** depth and clarity of strategy.
- **Managing for value:** how companies manage their financial resources from an economic and risks perspective.
- **Value platform:** critical investment in the activities/relationships that underpin value creation.

If a company is to project a coherent picture of its business, management needs to provide significant information in all four categories.

**Getting started**

The real challenge for most companies looking at moving to ValueReporting lies in identifying the current gaps in their own information and putting the right framework of information together. A further crucial element is linking the distinct ‘building blocks’ of information to create a coherent overall picture.

The key to achieving this is not to try to ‘cherry-pick’ the ‘right’ information. This approach helps no one and would act against creating the transparency which will ultimately benefit everyone. Instead, the company should set itself a long-term objective of progressively narrowing the ‘reporting gap’ between its internally used management information, and the information disclosed externally. This process is illustrated in Figure 4.

The implications of ValueReporting do not end with companies, but also extend to the role of accountants. Should the accounting function expand to absorb and integrate the new measures and information that are being reported? Or should traditional financial accounting be kept separate from the increasingly important and influential non-financial measures?

In our view, the only practical way forward is integration. Financial and non-financial information both feed into the same decisions, whether it is management or investors who are taking them. The logical conclusion from this is that ValueReporting is all about breaking down silos and creating a common bridge linking management accounting, financial reporting and investor analysis.

The breaking down of silos and the creation of a common bridge linking management accounting, financial reporting and investor analysis is inevitable, as the information that is important to understand value creation needs to be at the heart of all three elements of measurement and analysis. Perhaps the key is to remove the word ‘accounting’ from the discussion. The focus has to be on information, whether it be financial or non-financial. The end-game is the creation by a company of a comprehensive set of performance information and metrics, reflecting the shape of information in the ValueReporting Framework, which is used to manage the company, is used to drive external reporting, and which, for the investor, provides the majority of information required to make an objective investment decision. Today the three elements are unaligned and each element omits key elements of information, with perhaps the financial reporting model being the element most out of line.

Put another way, investors want to know what information management use to manage the business. Our research shows that there is a good deal of alignment between the views of investors and management as to what is important information in understanding value creation. A significant issue, however, for many companies today is that they do not have the information, or if they do they admit it is unreliable. At the end of the day, assisted by the impact of technology such as XBRL, we will face the world where companies have one database of information, carefully and coherently constructed, which is used to both run the business and communicate to all stakeholders. The only external reporting issue that management will have to decide is where they draw the line of transparency across this information set.
So how can change occur? First, all accountants need to be trained to understand the critical linkage between internal and external reporting, and raise their knowledge of what drives value (the value platform) and how it can be measured, monitored and managed. Second, the external reporting model has to be better aligned to the information used internally by management to manage the business – this is the heart of ValueReporting. Finally, management need to reassess whether they really understand what drives value, and whether the internal processes and metrics generate the information they and investors need to understand the future potential of the business.

About ValueReporting™

ValueReporting™ (www.valuereporting.com) was developed to help companies realise their full value in capital markets and to give investors and other stakeholders the information they need to make fully informed decisions about how a company is performing. The best value creation efforts of many companies often go unreported and unappreciated by the marketplace. After all, investors cannot value what they cannot see.

The ValueReporting Framework enables a company to communicate its value in a language that investors understand. This includes management’s view of the marketplace, its strategy for competing, its targets and objectives, and the assets – both financial and non-financial – the company considers most critical to its success.

ValueReporting in action: its use so far

In our experience to date, it is fair to say that no single company yet embodies all the elements of the full ValueReporting Framework in its corporate reporting model. But, as our ValueReporting Forecast 2002 clearly shows, every aspect of what we describe as ‘important information’ is being reported somewhere by one or more companies. This means that best practice is already starting to emerge in the application of ValueReporting™ in the real world.

In terms of the Market Overview quadrant, one of the best examples we have seen is the Bank of Montreal’s reporting on the macroeconomic environment, placing the outlook for its own business in the context of the Canadian, US and world economy.

In the area of Value Strategy, Boots plc’s Annual Report and Accounts 2001 describes the link between shareholder value creation and executive remuneration through the use of a shareholder value metric – total shareholder return (TSR) – as a key performance measure.

In terms of Managing for Value, Barclays Bank describes its use of value-based management (VBM) relative to its commitment to shareholder value creation.

And in the Value Platform arena, Ford Motor Company describes its commitment and approach to reducing its ‘environmental footprint’, and communicates its adherence to global reporting initiative (GRI) guidelines.

All these case studies, and many more, are explained and illustrated in: PricewaterhouseCoopers ValueReporting Forecast 2002

Strategic Enterprise Management (SEM)

The impetus for better disclosure is partly driven by the change in technology that supports financial operations. Sophisticated software has automated and integrated a lot of routine processing and ERP systems are designed to:

- provide a better understanding of the business
- increase accuracy of information and speed of delivery

However, ERP implementation in itself does not provide improved decision making and strategic management processes in an organisation. This can only be achieved by taking a strategic enterprise management approach that allows the best companies to sustain competitive advantage through a superior strategic management process.

The technologies that enable SEM which are being offered by the big software vendors will continue to evolve and it is likely that the next two years will see a growing number of ERP vendors and niche software firms offering SEM capability. In the long term, CIMA believes that sustainable competitive advantage from SEM will arise neither from the adoption of widely available software nor from techniques. More important will be each management team’s success in adapting the technologies and techniques to the unique operating environment and decision-making culture of their own organisation.

The CIMA SEM project is about organisations improving the quality and effectiveness of their strategic manage-
ment processes to secure a sustained advantage over competitors. Evidence to date suggests that successful corporations have in common a superior strategic management process. This involves not just business performance management, but also the more proactive areas of business problem solving, business learning, and business direction setting. It is only when this capability is in place that an organisation can begin to develop and sustain competitive advantage by enhancing decision making in important areas such as its:

- Choice of market
- Architecture
- Culture
- Value chain
- Strategic resources

Success in adopting a SEM approach can be measured broadly in two ways:

1. by how well senior executives feel they are able to empower their employees to run an organisation as efficiently as it can be run in the present day;

2. by having the necessary space themselves and the right information to develop a superior strategic management process that can take the company forward in the medium to long term.

In an SEM approach, the finance function can bridge the gap between strategy and operations by making shareholder value the key criteria in decision making and by providing the tools and information to support a SVM approach. This involves helping executives operationalise SEM by informing them what factors drive value and where value is created or destroyed. Improving the effectiveness of strategic management processes in terms of executing and adapting strategy is achieved by providing better business intelligence capability in the form of information captured from within the organisation and from the external environment in which it operates.

SEM also helps management monitor and communicate strategic and operational objectives by providing a real-time measurement of value drivers and reporting on their impact on organisational performance. It is an approach which will therefore aid transparency with all stakeholders and provide the basis for improved reporting externally.

CIMA is leading the thinking in this emerging area via its Round Table of CFOs, consultants and academics. As well as providing various opportunities for the participants, particularly in terms of learning through shared experiences and case studies, CIMA is using this forum to promote the advantages of a SEM approach and good practice in this field. For more information and resources on SEM, please see:

www.cimaglobal.com/main/resources/developments/sem/

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**Technological changes**

**Fast closing**

The impact of new technology has been pervasive in other areas. Speed itself has become a source of competitive advantage – technological innovation is shortening product life and capital investment cycles. Indeed, speed to market has become crucial. Thanks to web-enabled tools, industry leaders such as Cisco have pioneered different ways of getting information out in as little as a day.

Fast closing is not an end in itself. Instead, it should become an opportunity to sort out all the inefficiencies that make the month-end close such a drudgery for finance professionals. Put simply, there is little point in embarking on a complex programme of change to achieve a fast close if the underlying process is flawed to start with. Fast closing should be about reliability and relevance as well as speed. Fixing the basics will increase management confidence in the numbers produced both for internal reporting needs as well as for current and potential investors. Companies willing to undertake comprehensive albeit costly reviews of their processes will inevitably be seen as more proactive and better managed and controlled than their competitors. This is no small advantage in an environment where strategy and the quality of management rather than the tangible assets can distinguish a company and attract investors.

Although apparently a purely operational issue, fast closing can clearly generate benefits on a more strategic level. It will in effect mean that key financial information will be available on a timely basis. This should, in turn, improve forward planning, decision-making and external reporting. Problems can be spotted and rectified before it is too late, and up-to-date information will allow more informed decision-making. The emergence of best practice can also be observed in the way many companies are now beginning to narrow the gap between the time of close and the time of reporting to markets.

Web-enabled technologies, the unprecedented speed and ubiquitous nature of the Internet, have forced many businesses to become 24/7 operations transcending distance and time differences. The Internet has made information widely available, easily accessible and – most importantly – cheap.

Although many members of the investment community still expect a glossy annual report, more and more companies are using their websites to communicate with the market. A convenient and cost-effective communication tool, a company website can include not only the latest accounts or financial reports but also interactive webcasts, videos and so on. For example, the preliminary results for 2001 from WPP Group plc on a website devoted exclusively to investor relations include not only the main text and the relevant tables but also an audio presentation with synchronised slides and a pdf presentation document (www.wppinvestor.com). There are,
however, some remaining concerns about the reliability of online accounts, as it is technically possible to alter them after they have been audited.

A research report by ICAS entitled *Business Reporting: Harnessing the Power of the Internet for Users* (2002) highlighted the fact that, although the Internet is becoming accepted as a medium for delivering financial data, it is unlikely to replace human interaction.

**XBRL**

The nature of the information contained in online financial reports is likely to change, however, with the language used for Internet reporting. HTML – or Hypertext Mark-up Language – which tags every page in the Internet, provides a format in which relevant information is displayed. Although it tags the information displayed in the browser, the tags only serve to present the information in a certain way – such as in italics or in tables. It simply displays the information without being able to ‘read’ or make sense of it, so it does not allow it to be analysed or compared in any way.

Enter XML – Extensible Mark-up Language. It is an electronic reporting language that functions across all software and technologies, including the Internet. Its advantage is that it tags information in a way comparable to a bar code so that each individual piece of data is described in a comprehensive way, regardless of the format.

**XBRL – Extensible Business Reporting Language** – is an open specification for the reporting of financial information in XML. Its primary aim is to enhance the transparency and usability of all financial data (and, at a later stage, non-financial too) on a global scale. Its potential is based on taxonomies – XML-based data tags that describe financial statements and are available for universal use by all members of the financial information supply chain.

It provides the financial community with a defined framework to prepare, publish, extract and automatically exchange financial statements. It is therefore about changing the process of disclosure rather than establishing and enforcing new standards.

In March this year, Microsoft started reporting in XBRL for the first time, claiming that it expects to see a quick return on its investment. Only Reuters and Morgan Stanley Dean Witter have so far published their financial data in this way. However, XBRL has had enormous stakeholder support and international participation. As Bob Eccles, principal at Advisory Capital, a US consulting firm specialising in financial reporting, says in the *Financial Times* (5 March 2002):

> This is just like a fax machine. If only a few companies are publishing in XBRL, it is not much use. We need a collective movement to encourage companies to go with us.

XBRL has several key aims:

- To enable business reporting that leverages the Internet so that web browser searches are more efficient and relevant. An XBRL-based financial statement is a digitally enhanced version of a paper-based one that includes the balance sheet, income statement, statement of equity, statement of cash flows and the notes to the financial statements as well as the auditor’s report.
- Effective access and analysis of business reports for both internal and external users. Computer programs will be able to easily extract every piece of information in a financial statement.
- Improve corporate communications with stakeholders and enhance financial information through the supply chain.

In future, the aim is to develop business reporting for XBRL so that taxonomies carry non-financial data.

The envisaged benefits of XBRL to end-users include:

- Reduced cost of reporting and analysing financial and other information.
- Increased speed and efficiency of business decisions.
- Enhancing the distribution and access of existing financial statement information.
- Increasing and enhancing analysis, i.e. investors, analysts, regulators and other users can spend more time analysing information rather than simply looking for it. Analysis can be automated and presented in different formats. Nasdaq estimates (*Financial Times*, 5 March 2002) that about 10,000 publicly listed companies in the USA are not covered by Wall Street analysts – part of the reason for such a large gap must lie in the forbidding cost of collecting information. XBRL should make it easier and cheaper to do this.
- Increasing transparency and therefore accountability of financial reporting.

Its critics claim that, despite the alleged benefits, XBRL will do nothing to actually improve the current system of reporting. Electronically tagging financial information does not necessarily lead to that information meaning anything more. Some claim that XBRL could in fact make matters worse by enabling different companies to report identical items in more than one way. In addition, it may not put any additional pressure on companies to disclose meaningful information online – the same accounting games will continue to be played, only digitally.

Although some of the objections to XBRL may be construed as valid, they run the risk of divorcing style – the format in which the information is presented – and content in a very simplistic manner. Information is never neutral – it is always partly defined or constrained by the way in which it is presented.

The international effort to create taxonomies and define individual data tags will have to start from some kind of consensus about what to call particular reporting items.
There will always be room for deviation but it should be no worse than what is available at the moment. In fact, one can hope that the predicted mass move to XBRL (the list of companies subscribed is impressive) will push companies to first simplify and then standardise existing financial information. The increased speed and analytical capability should in turn lead to other improvements in the content of the information that makes up financial statements.

The impact of XBRL may initially be more evident in internal reporting, say, between subsidiaries as they are likely to use the same accounting policies. The proliferation of new organisational forms based on partnerships or networks and the global and fragmented nature of many of today’s supply chains will play their part in the move towards consolidation.

Admittedly, XBRL cannot achieve this in isolation. But alongside all the other drivers for change, it should play its part in revolutionising external reporting. Web-enabled technology has united traditional financial reporting and the Internet in a way that will increase the speed and the accuracy of gathering and disseminating relevant financial information.

International Accounting Standards

The push for more transparent and exhaustive reporting has been partly driven by regulatory pressures. In the last two years, several significant developments have taken place in the realm of international accounting standards and the harmonisation of financial reporting regimes:

- The International Accounting Standards Committee completed its programme of core standards (December 1999);
- The International Organisation of Securities Commissions recommended that multinational enterprises should be able to use International Accounting Standards (IASs) for financial statements for cross-border listings and offerings (May 2000);
- The USA’s Securities and Exchange Commission (SEC) is considering whether it will accept financial statements in IASs from foreign registrants without restatement or reconciliation to US GAAP (concept release published February 2000);
- The EU proposal requiring all companies listed on a regulated market within the EU to prepare group financial statements using International Accounting Standards in place of national standards was ratified by the Council of Ministers (June 2002).

The most significant development, from the viewpoint of UK listed companies, is the EU decision. It means a lot of work within a very tight timescale for standard-setters, preparers of the financial statements, auditors and users.

The deadline for the implementation of the EU regulation is January 2005. In addition to listed companies preparing their accounts using IASs, the regulation gives member states the option to extend the requirement to unlisted companies as well as single entities. This may encourage the total replacement of national standards with IASs as many member states might wish to avoid having separate regimes for listed and unlisted companies.

The intention behind the proposal is to make financial statements of organisations from anywhere in the EU – and hopefully the world – comparable. This, in turn, would eliminate barriers to cross-border trading and reduce inequalities in the cost of raising capital. In fact, capital market efficiency and the consequent boost to the EU economy is the main driver behind the proposal. In addition, some envisage that it will improve shareholder dialogue and the clarity of strategic direction for the organisations directly affected by the requirements.

The points worth bearing in mind are:

- **Enforcement mechanism**
  A two-level mechanism is in place: an Accounting Regulatory Committee operating on a political level, which is supported by a technical committee, the European Financial Reporting Advisory Group (EFRAG). This group is made up of representatives from the various constituencies with an interest in financial reporting – users and preparers of accounts, national standard-setters and the accounting profession.

- **Further EU regulation**
  The European Commission will continue its financial reporting work by modernising two of the existing Accounting Directives (the 4th Company Law Directive and the 7th Directive on consolidated accounts) over the next two years.

- **IASB work programme**
  The general consensus is that almost all the current IASs will be revised over the next few years. The current agenda for the IASB was published on their website on 27 June 2002 with convergence a priority.

- **ASB work programme**
  The ASB itself acknowledges that this would not be the right time to introduce new UK standards – its priority is to assist in the convergence programme. In May, the ASB published for comment Financial Reporting Exposure Drafts of proposed UK accounting standards, aligned with IAS:
    - Foreign currency translations;
    - Related-party disclosures;
    - Earnings per share;
    - Post balance sheet events;
    - Inventories, construction and service contracts;
    - Tangible fixed assets;
    - Financial instruments.

- **Training and education**
  More emphasis will need to be placed on International Accounting Standards in the syllabi of all the professional bodies. Accountants who qualified before these...
standards became relevant will need to ensure they update their knowledge sufficiently to understand their application and interpretation. The *Convergence Handbook* is a useful starting point for UK accountants.

The *Convergence Handbook*, prepared for the ASB by the ICAEW, was published in November 2000. It compares different treatments for various issues under international and UK standards and suggests solutions for convergence. The solutions include the adoption of the best of both UK and international standards.

The *Handbook* was originally a consultation document. CIMA’s contribution, echoed by other contributors, was a plea not to worsen the impact of these changes by introducing further changes to national standards that would have a limited life before being overtaken by harmonisation. Subsequently, the implementation of FRS 17 has been delayed.

It is probably too early to judge whether the internationalisation of accounting standards will in fact be worth the effort on behalf of the standard-setters, the costs incurred by the business community and the investment in training by professional bodies and individual accountants. The ultimate goal, of course, is transparency and comparability. At the moment, the case of Enron and the pre-emptive US approach seem to have revealed the potential benefits of replacing national standards with IASB ones and aiming for a principles-based approach. If harmonisation can be achieved, it is ultimately worth the effort, although there will inevitably be risks involved.

The Financial Accounting Standards Board in the USA is currently exploring the possibility of adopting standards that emphasise basic principles and objectives rather than detailed rules, exceptions and alternatives to the underlying principles. Such standards would place the focus on accounting for the substance of a transaction rather than its form.

Although all the EU countries are involved in the proposed IAS changes, the effect on the UK is likely to be unique. Not only does it have the highest number of listed companies but – arguably – also has the best standards in the EU.

Introducing IASs is a major step towards consistency and comparability, but sceptics like to point out that cultural and language differences leave enough room for different interpretations, although they will be translated. There are other potential problems too – for example, whether companies will be required to report quarterly, rather than biannually as at present. There will also be issues about specific sector requirements.

The *Handbook* is a useful starting point for UK accountants.

**Company Law Review**

When British company law was created in the 19th century, it was a source of competitive advantage. Now it has become a competitive disadvantage. The law has become encrusted with amendments and case law over generations. It has failed to adapt to meet the changing role of small enterprises.

Patricia Hewitt’s preface to *Modernising Company Law White Paper July 2002*

In the UK, following three years of extensive consultation, the Company Law Review has been completed and the final draft submitted to the Secretary of State for Trade and Industry at the end of July 2001. Although the government is not expected to table formal proposals within the current parliamentary session, the developments outlined in the report are likely to be included in the updated Companies Act in 2003.

In July 2002, the Secretary of State for Trade and Industry, Patricia Hewitt, published a White Paper entitled Modernising Company Law which invites comments on how the recommendations of the Final Report are implemented. Responses should be sent by 29 November 2002.

The *Strategic Framework* (Company Law Review Steering Group, 1999) states:

- Company accounting and reporting remains essentially backward looking and based on financial indicators. There are few statutory requirements to report on the main qualitative factors which underlie past and future performance (or for future performance, even financial factors) – in particular on strategy, prospects, opportunities and risks; on intangible, and so-called ‘soft’, assets (which may contribute significantly to success but are not well captured in traditional financial statements); and on key business and wider relationships. As a result, the information provided is defective and directors do not have the discipline of accounting for stewardship on some key responsibilities.

As the above quote illustrates, an important aspect of the Company Law Review has been to reassess the structure and process of current financial reporting practices with a view to increase ‘corporate responsiveness to wider interests through transparency and accountability’ (*Strategic Framework*, 1999). It essentially acknowledges that the information currently provided by the majority of companies is not only backward looking (and thus gives no real indication of future performance) but also fails to recognise that ‘in the course of generating wealth companies may cause various kinds of external harm of which society disapproves – damage to health and safety, abusive employment or contracting practices, and environmental damage’ (ibid.). It therefore calls for companies to address the issue of transparency by disclosing more and
better information about their performance and how it affects a variety of stakeholders.

As they presently stand, directors’ statutory duties to others beyond the owners of the company are minimal. There have been proposals to redefine them along the lines of the so-called ‘pluralist’ approach where companies are required by law to serve a wider range of interests ‘not subordinate to, or as a means of achieving, shareholder value … but as valid in their own right’ (ibid.). The companies would therefore have to juggle a number of equally legitimate interests and seek suitable trade-offs between them.

This approach was rejected as unfeasible – companies would in reality become accountable to everyone and no one at the same time. Instead, the change put forward was for a mandatory rather than voluntary Operating and Financial Review (OFR). It would rectify the current anomalies by redefining their duties to take into account wider stakeholder interests while maintaining their legal accountability to shareholders alone.

It goes some way to transforming both what and how companies report as their main measures of performance. Besides traditional financial measures, they will be required to include an account of how the company’s intangible assets contribute to overall value generation and how the conflicting stakeholder interests are balanced.

It must not end up being just a checklist, as boiler-plate reporting will always be ineffective. It should contain what the directors think is important.

The Final Report from the Company Law Review (2001) specifies the areas to be covered in the new OFR as the following:

Always required:

(i) The company’s business and business objectives, strategy and principal drivers of performance.
(ii) A fair review of the development of the company’s and/or group’s business over the year and position at the end of it, including material post-year-end events, operating performance and material changes.
(iii) Dynamics of the business – i.e. known events, trends, uncertainties and other factors that might substantially affect future performance, including investment programmes.

Required to the extent material:

(iv) Corporate governance – values and structures.
(v) An account of the company’s key relationships, with employees, customers, suppliers and others, on which its success depends.
(vi) Policies and performance on environmental, community, social, ethical and reputational issues, including compliance with relevant laws and regulations.
(vii) Receipts from and returns to shareholders.

It is clear from the above list that some of the information provided in this way will not be quantitative – in fact, the Final Report explicitly states that the OFR ‘is a qualitative, as well as financial, evaluation of performance, trends and intentions, prepared by the directors from their perspective as managers of the business’.

Rather than issuing detailed mandatory requirements, the OFR focuses on directors’ judgement to provide a relevant account of their companies’ performance.

Corporate governance has been retained as a separate heading on the above list despite the fact that the reporting of risk is in fact covered by items (i), (ii) and (iii). The Steering Group stresses that the reason for this is that item (iv) is in fact concerned with ‘controlling and focusing the powers of management’ and not with the specific risks or ways to combat them.

There are, of course, problems with a forward-looking OFR that requires companies to increase their disclosure on risk. According to the Gee Corporate Governance Handbook, when finance directors were asked about risk reporting, their main concern was being held hostage to fortune if suddenly faced by unexpected events. They also expressed discomfort about being a ‘what if’ company and worried that the premature announcement of a potential risk could damage their share price. In addition, they claimed that if the risks were becoming significant enough, they would not wait until the OFR to announce it.

As the Handbook suggests, the OFR could become a victim of its own versatility – in a 1998 discussion paper, the ICAEW called for a separate and specific statement of risk. Any further developments in this area will be crucial as the importance of disclosing risk moves higher up the corporate agenda, thanks to Enron.

CIMA fully supports the OFR. We see it as a positive step in improving transparency by enhancing public reporting to stakeholders on long-term issues. We are currently contributing to the debate on what the OFR should include through a research project and a planned response to the White Paper.

The common complaint among companies is that it is difficult to obtain, categorise and analyse non-financial data – FEE (Fédération des Experts Comptables Européens – European Federation of Accountants) states that ‘it should be recognised that the subject matter is often very subjective and … social accounting lacks the rigours of financial accounting. For verification to be effective, there should be clearly defined guidelines for the preparers of the information reported’ (Response to the Green Paper Promoting a European Framework for Corporate Social Responsibility, 2002).

The overall message of the Company Law Review has been to get companies to consider their multiple accountabilities to a range of different stakeholders. CIMA
research on shareholder or stakeholder value shows that even those companies that explicitly subscribe to Value-based Management (which advocates the primacy of shareholders’ interests), nevertheless recognise the importance of at least three primary stakeholders – shareholders, customers and employees (Cooper et al., 2001). The researchers go on to say:

… we see that all are treated as important to the business and their interests balanced out, although there is a tendency to treat shareholders as more important – and hence have more attention paid to them – than the other stakeholders whatever philosophy of performance management has been adopted.

They cite the almost universal adoption of some form of a balanced scorecard technique as evidence of the companies’ attempt to balance various stakeholder interests.

The discourse of financial reporting has in fact been shifting for some time from ‘an economic view of corporate performance measurement to an informational perspective with a recognition of the social implications of an organisation’s activities’ (Beaver, 1998, quoted in Cooper et al., 2001). The pioneers of corporate social reporting would like the companies to go even further in their practices – they call for reporting that would reflect the company’s impact on societies, communities and the environment in which they operate in pursuit of shareholder value.

This represents the so-called triple bottom line where companies would have to relinquish their traditional focus on financial bottom line and consider the impact of their performance on environmental quality and social justice.

Sceptics say that the only way the environmentally friendly and socially responsible practices and the more transparent reporting frameworks will become widespread is if they are accompanied by a big regulatory stick. FEE believes, as do many other commentators, that corporate social reporting should be left to develop in a voluntary setting, stimulated by market forces.

But it is worth bearing in mind the potential consequences of ignoring the current trend. Even if the government does not intervene (as it did when it introduced the Landfill Tax or the Climate Change Levy), companies are facing serious reputational risks where they could be penalised by customers for failing to be leaders in the field. The whole concept of corporate risk will probably have to be redefined.

This process is already under way. In 1997, the Hampel Committee suggested that directors should be made responsible for monitoring non-financial risks and controls, as well as traditional financial ones. In 1999, the Turnbull Committee confirmed that company boards should consider all relevant risks, including environmental ones.

FEE, in its response to the European Commission’s Green Paper Promoting a European Framework for Corporate Social Responsibility, states that:

… there is the business case for CSR (Corporate Social Reporting) including sustainable development, risk, corporate reputation and ultimately shareholder value, even though this may often attract little attention in comparison with short-term issues.

However, there is plenty of evidence that companies are already treating the corporate social reporting and sustainability agenda as an important part of their competitive strategy. They can gain market advantage through ‘green’ products, ethical investment and so on. This has in turn led to the creation and adoption of voluntary standards. The ones currently tested in UK companies are:

- AA 1000: developed by the Institute for Social and Ethical Accountability;
- The Global Reporting Initiative: developed by a wide range of international organisations;
- ISO 14001: developed by the International Standards Organisation;
- Project Sigma: a sustainability management standard under development by the British Standards Institution, Forum for the Future and others.

**Global Reporting Initiative**

Global reporting initiative (GRI) is a ‘long-term, multi-stakeholder, international undertaking whose mission is to develop and disseminate globally applicable sustainable reporting guidelines for voluntary use by organisations reporting on the economic, environmental and social dimensions of their activities, products and services’ (www.globalreporting.org). It arose from the need to address the failure of the current governance structures to respond to changes in the global economy.

In June 2000, GRI published a set of sustainability reporting guidelines. It envisaged them to be used as a decision tool in three ways:

- At the level of the governing body, the guidelines provide an internal vehicle for evaluating the consistency between the organisation’s economic, environmental and social policy and its actual performance. The increased uniformity in reporting facilitated by the guidelines will help reporting organisations to compare themselves with others and to recognise improved performance.
At the operational level, the guidelines provide a logical structure for applying sustainability concepts to the organisation’s operations, services and products. They also help guide the development of data and information systems for setting and tracking progress towards economic, environmental and social goals.

From a communications standpoint, the guidelines provide a framework for effectively sharing and promoting dialogue with internal and external stakeholders regarding the organisation’s accomplishments and challenges in achieving its goals.

The guidelines are based on several detailed underlying principles such as that of reporting entity, reporting scope and period, conservatism, materiality and so on. They classify the performance reporting elements into:

- categories (the broad areas of concern to stakeholders, e.g. air, energy, etc.);
- aspects (general types of information related to a specific category such as child labour practices); and
- indicators (specific measurement of an individual aspect that can be used to track and demonstrate performance).

The indicators themselves are divided into:

- environmental (generally applicable and organisation-specific);
- economic;
- social;
- integrated (systemic – linking performance at the micro-level with economic, environmental or social conditions at the macro-level – and cross-cutting – bridging information across two or more of the three sustainability elements of an organisation’s performance).

For example, the indicators for social performance are split in the following manner:

**Wages and benefits**
- Ratio of lowest wage to national legal minimum.
- Ratio of lowest wage to local cost of living.
- Health and pension benefits provided to employers.

**Non-discrimination**
- Percentage of women in senior executive and senior and middle-management ranks.
- Discrimination-related litigation – frequency and type;
- Mentoring programmes for minorities.

**Training/education**
- Ratio of training budget to annual operating costs.
- Programmes to foster worker participation in decision-making.
- Changes in average years of education of workforce. Incorporate achievement associated with training programmes.

**Child labour**
- Verified indices of non-compliance with child-labour laws.
- Third-party recognition/awards for child labour practices.

**Forced labour**
- Number of recorded grievances by employees.
- Incidents identified through organisation’s auditing of suppliers.

**Freedom of association**
- Staff forums and grievance procedures in place – percentage of facilities and countries of operation.
- Numbers and types of legal actions concerning anti-union practices.
- Organisational responses to organising at non-union facilities or subsidiaries.

**Human rights**

**General**
- Demonstrated application of human rights screens in investment.
- Evidence of systematic monitoring of organisational practices.
- Number and type of alleged violations, and organisational position and response.

**Indigenous rights**
- Evidence of indigenous representation in decision-making in geographic areas containing indigenous peoples.
- Number and cause of protests.

**Security**
- Examples incorporating security and human rights into country risk assessment and facility planning.
- Remuneration/rehabilitation of victims of security force action.
**Suppliers**
- Performance of supplier relative to social components of programmes and procedures described above.
- Number and type of incidents of non-compliance with prevailing national or international standards.
- Frequency of monitoring of contractors regarding labour conditions.

**Products and services**

Major social issues and impacts associated with the use of principal products and services. Include qualitative and quantitative estimates of such impacts, where applicable.

**Customer satisfaction levels**

As is obvious from the above examples, the GRI guidelines prescribe the use of quantitative data. They encourage reporters to express the information as ratios as well as providing absolute values, as this makes the information easier to interpret and understand.

However, GRI also suggests the use of qualitative criteria that would enhance the credibility of reported data. They consider the main qualitative characteristics to be:

- relevance;
- reliability;
- clarity;
- comparability;
- timeliness; and
- verifiability.

More and more companies are beginning to use the framework for performance measurement and reporting, and in April this year, the GRI was officially inaugurated as a global institution at a launch in New York. For further details check www.globalreporting.org.

**Sustainable development**

In its response to the aforementioned Green Paper on corporate social responsibility, the European Federation of Accountants noted that the term triple bottom line itself is no longer up to date and the use of the terms sustainability or value reporting is preferred. They add that ‘corporate social reporting needs to be approached within the total framework of corporate governance within which each stakeholder should assume responsibility’.

Sustainable development is a key concept that informs much of the current discussion around social reporting. The World Commission on Environment and Development defines it as:

Development which meets the needs of the present without compromising the ability of future generations to meet their own needs.

Any mention of sustainable development in relation to business begs the obvious question about the nature of the role of business in society. What is its primary objective? Who does it serve and who should it be accountable to? Classic economic theory assumes that the main purpose of business activity is to generate wealth for shareholders. Looking after social or environmental problems is often seen to be the duty of governments. This would appear to be directly at odds with the concept of multiple stakeholders and broader accountability.

But it is probably best not to think about sustainability as a destructive step that asks for a demolition of many of Western society’s long-held beliefs about business, including the supremacy of profit. Without being profitable, no business would ever be in a position to do any good for society. Instead, sustainability should be thought of as an extension or a more transparent way of presenting the implicit contract that has always existed between business and society.

The two cannot exist in isolation. On the one hand, society provides the raw materials and labour, infrastructure, means of exchange such as money, and a safe and stable social environment with a legal and police system. On the other, business satisfies material needs with goods and services, provides means of wealth generation and employment and also has a commitment to investment and innovation (Open University, 2001).

The current sustainability discourse is still very fuzzy. We have yet to develop a set of universal metrics or even a language that would make the exchange of ideas easier. A lot of what has been written about it in the context of financial accounting has focused on making what you do more transparent. But ultimately, real sustainable development is about changing what you do, about making changes to value chains. This is why we are still struggling to find a way of talking about it.

The challenges for the finance function will be enormous. The first stage will be to install performance measurement methods and indicators, followed by an audit system to verify them. Only then should companies attempt to publish their accounts for public scrutiny. Management accountants are best placed to develop, test and implement such frameworks.

In a rush to jump on a bandwagon of sustainable development, many companies may be tempted to start reporting their activities externally without first implementing robust management systems capable of providing the relevant information. As mentioned several times already, publishing vague qualitative data is worse than just sticking to the financial bottom line. As it has no hard data to qualify it, it fails to be informative or comparable, and is therefore of no use to current or potential investors.

John Elkington (1997) compares the actual and the ideal chronology of reporting:
For further information on sustainable development, please see CIMA’s forthcoming executive briefing on the subject.

Conclusion

Either way, finance professionals, especially management accountants, will play a key role in preparing and synthesising relevant information to be communicated to the markets. In this way, management accounting can become a strategic necessity for tomorrow’s company. This has serious implications for the future of the finance function.

Despite the strengths of the current system, there is clearly a need to modify existing accounting practices to better serve the needs of the financial community. There is a growing recognition that its historical focus and a very narrow definition of value, together with the underlying culture, have impaired its functioning.

Although there is no clear consensus about what the business reporting of the future will look like, it is heartening to see the increasing level of activity by everyone involved in the financial supply chain including, standard-setters and the companies themselves.

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