

Information for Better Markets

New reporting
models for business

The Institute of Chartered Accountants in England and Wales is the largest professional accountancy body in Europe, with over 125,000 members in 142 countries. Its members around the world are involved in every aspect of business and reporting. They play key roles on company boards, prepare internal and external reports, perform audits, act as investment analysts, take investment decisions as managers, entrepreneurs and investors, and work as regulators and standard-setters.

This report forms part of the ICAEW's Information for Better Markets campaign. The ICAEW believes that the information available to markets could be significantly improved. To make real progress in this direction, the ICAEW will be exploring key underlying issues in business reporting by preparing a series of reports, hosting related debates involving interested parties, commissioning follow-up research, and making properly grounded and practical proposals.

Prospective Financial Information: Guidance for UK Directors, the first of these reports, was published in September 2003 and illustrates what can be achieved by an inclusive and considered approach, even in the most challenging areas of business reporting. This report, *New Reporting Models for Business*, is the second in the series. Comments are invited by 31 March 2004.

If you are interested in following the progress of the campaign or in details of future reports and consultations, please visit the Institute's website at www.icaew.co.uk/bettermarkets. Anybody wishing to contribute to the ICAEW's work is particularly welcome. Please register via the Institute's website or email bettermarkets@icaew.co.uk.

Additional copies may be obtained by calling:
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An initiative from the Institute of
Chartered Accountants in England & Wales

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Executive summary

There has been growing concern internationally in recent years that business reporting is inadequate. There are many ideas as to how it should be reformed, but there is no agreement on what should be done.

The ICAEW is committed to help move business reporting forward and this report is designed to enlist the support of investors, managers, regulators and commentators who share this commitment. Are fundamental reforms required? If so, what should they look like and how should they be implemented? To make sure that future work is built on firm foundations, this report seeks to identify the underlying issues.

The basis of the report is summaries of 11 key proposals for new reporting models (Chapter 4). The proposals considered are:

1. The Balanced Scorecard (Kaplan and Norton)
2. The Jenkins Report (AICPA)
3. Tomorrow's Company (RSA/Tomorrow's Company)
4. The 21st Century Annual Report (ICAEW)
5. The Inevitable Change (ICAS)
6. Inside Out (ICAEW)
7. Value Dynamics (Arthur Andersen)
8. GRI (Global Reporting Initiative™)
9. Unseen Wealth (Brookings Institution)
10. ValueReporting™ (PricewaterhouseCoopers)
11. The Hermes Principles (Hermes Pensions Management)

None of these models, whatever their merits, has so far succeeded in commanding general support. At present, they provide a collection of interesting and challenging ideas, many of which seem to have little prospect of widespread implementation. Rather than put forward yet another new reporting model to compete in an already crowded market, this report adopts a different approach. It analyses the models from a change management perspective to illuminate the reasons for their limited success to date and raises a series of questions for further discussion and research (Chapter 3). The report uses a framework of seven key questions for reformers:

1. What is the **problem**?
2. What is the **solution** to it?
3. What is the **desired result** that the solution would deliver?
4. Who is **responsible** for implementing the solution?
5. What is their **motivation** for implementing it?
6. What **practical difficulties** will they encounter?
7. What is being done to **monitor progress**?

Building on this analysis, the report identifies six underlying issues on which there is deep disagreement between reformers and established opinion (Chapter 2). Views on these issues, though firmly held, are often less firmly supported by evidence. They are therefore issues on which there is a need for research to establish facts and test arguments and for dialogue to bring different parties together to explore their differences. In this way, it should be established which ideas deserve to be translated into action and how best this can be done. The six key issues are:

1. Can business reporting serve multiple stakeholders?

No, according to the established view. Business reporting should be determined by the needs of investors, but fortunately there is a large overlap between investors' needs and other stakeholders'. Yes, say many reformers. Different stakeholders have different needs for information, but fortunately modern technology will allow multiple stakeholders to access precisely the information they want. (We refer to this as the *multiple stakeholders* question.)

2. Can business reporting meet all decision-making needs?

No, according to the established view. Business reporting plays an important role in investors' decisions but there needs to be recognition of the importance of other sources of information such as direct experience of the business or contact with management. Yes, say many reformers. They give reporting a more important and comprehensive role and attribute stock market volatility, bubbles and slumps to the alleged defects of today's reporting. (The *decision-making* question.)

3. Can business reporting depend on the invisible hand?

No, according to the established view. Ultimately, regulation drives progress, not self-interest and market forces. Without regulation there is no comparability and bad reporting drives out good. Yes, say many reformers. Change imposed by regulation results in token compliance and boilerplate rather than useful information. Improvement can and should be left to market mechanisms. (The *invisible hand* question.)

4. Can business reporting benefit from a new conceptual framework?

No, according to the established view. The existing conceptual framework of the accounting standard-setters is perfectly adequate. Yes, say many reformers. The framework needs to be developed to reflect the needs of all stakeholders for non-financial and forward-looking information, and the importance of intangibles. (The *conceptual frameworks* question.)

5. Can business reporting attach values to all intangibles?

No, according to the established view. Intangibles are nothing new and existing management and reporting techniques can cope with them. Yes, say some of the reformers. The rise of intangibles has changed the modern economy and only radical changes in reporting will enable businesses to respond appropriately. (The *intangibles* question.)

6. Can business reporting achieve transparency?

No, according to the established view. Transparency in business reporting is significantly constrained by considerations of cost, competition, confidentiality and litigation. Yes, say many reformers. There should be almost no limits on transparency. (The *transparency* question.)

On all six of these fundamental issues the ICAEW is committed to work at a national and international level with interested parties to invite views, host discussions and encourage research. The purpose is not to force acceptance of a new reporting model that has already been decided on, but to facilitate agreement on how reporting can be improved.

By way of practical illustration, the ICAEW's recent report *Prospective Financial Information: Guidance for UK Directors* extends the application of the existing conceptual framework of the accounting standard-setters to important new types of forward-looking information. It is the result of a rigorous due process applied during two public consultations and reflects a high degree of consensus among key stakeholders.

The ICAEW is particularly interested in facilitating international moves to improve statements such as the operating and financial review and management discussion and analysis. Many advocates of new reporting models see this as fertile ground for their ideas. However, the analysis in this report suggests that success will depend upon deep-rooted beliefs – beliefs about the extent to which business reporting can serve multiple stakeholders, meet decision-making needs, rely on the invisible hand, benefit from an expanded conceptual framework, attach values to intangibles and achieve transparency.

Invitation to comment

Comments are invited on the following:

- 1. Do the new reporting models summarised in the report cover all major strands of recent thinking on business reporting? If not, which models would you add and what insights and ideas do they offer?**
- 2. Is the change management approach adopted in the report appropriate? If not, what changes would you propose and how would they affect the analysis of the new reporting models?**
- 3. Are the questions for further discussion and research identified in Chapter 3 worth asking? If not, what questions would you add to or delete from the list?**
- 4. Do you wish to put forward answers to some or all of the questions posed in Chapter 3 and, if so, what are they and how are they supported?**
- 5. Are the six underlying issues identified in Chapter 2 the right ones? If not, what issues would you add to or delete from the list?**
- 6. Based on experience, examples and other evidence, what are your views on the six underlying issues and the work that needs to be done on them?**

Comments received will be analysed and summarised in accordance with the questions listed above, and used as a basis for decisions on the Institute's next steps. All replies will be regarded as on the public record.

To arrange a meeting or conference call to discuss your views with members of the ICAEW staff, please send an email to: newreportingmodels@icaew.co.uk.

Please send written comments by 31 March 2004 to the email address above or to:

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1. Introduction

1.1 Demands for reform

There has been growing concern in recent years that corporate reporting is inadequate. Exactly why it is thought to be inadequate varies from one commentator to another; some say that it has failed to adapt to the changing nature of business, some that it no longer meets the changing needs of investors, others that it fails to recognise a wide enough circle of users. And while some critics demand particular changes, others offer comprehensive programmes of reform, 'new reporting models' – a phrase used in the Institute of Chartered Accountants in Australia's report, *New Directions in Business: Performance Reporting, Communications and Assurance*, written by Michael Bray of KPMG.

The need for some degree of more or less fundamental reform – for whatever reason – seems to be widely accepted, yet there has been no agreement on how corporate reporting should be reformed, and there is no sign of such agreement emerging. Important changes to corporate reporting are taking place: International Financial Reporting Standards (IFRS) are being improved ahead of adoption in the European Union and elsewhere in 2005; corporate governance disclosures are being substantially increased; the operating and financial review (OFR), management's discussion and analysis (MD&A) and similar statements provide valuable new information; more and more is being disclosed on company websites. But these changes are occurring in a piecemeal way and none of them as yet fully addresses the concerns of corporate reporting's critics.

Much of the criticism of business reporting built up during the 1990s and was partly fuelled by concern at the growing gap between the values shown in company balance sheets and the stock market valuations of the same companies. Events of the past three years may appear to have diminished the force of these critics' arguments as the bull market has collapsed, reducing the gap between balance sheet and market values. And accounting scandals, particularly in the US, have focused attention instead on the importance of maintaining the integrity of traditional financial reporting.

Some may feel that more wide-ranging reforms should take second place for the foreseeable future to such pressing concerns as the improvement and implementation of IFRS. But the criticisms of business reporting referred to in this report did not suddenly appear at the height of the bull market and they will not disappear as and when companies are using a common set of international accounting standards. When these issues have been dealt with, the fundamental questions that the reformers raise will still need to be addressed. Indeed, unless they are addressed it might not be possible to restore or maintain confidence in business reporting.

In one respect, current developments in business reporting do seem to suggest that some of the issues on the reformers' agenda will not only be addressed, but may even be implemented, at least by the largest companies. The OFR and MD&A should provide valuable new information and the emerging trend internationally is for such statements to be made mandatory and for progressively more detailed requirements and guidance to be issued on their content. Recent, current and proposed projects in this area include:

- The International Accounting Standards Board (IASB)'s project on management's discussion and analysis.
- The Canadian Institute of Chartered Accountants' *Management's Discussion and Analysis: Guidance on Preparation and Disclosure*.

- The consultation document issued by the UK Department of Trade and Industry's Operating and Financial Review Working Group on Materiality, which will complement a planned statutory requirement for large companies to prepare an OFR.
- *Redefining Materiality: Practice and Public Policy for Effective Corporate Reporting*, issued by the Institute of Social and Ethical AccountAbility (also known simply as AccountAbility).

Proponents of new reporting models, which may seem remote and theoretical to those in business, see an opportunity in the OFR and MD&A to shape the debate on immediate and practical changes in business reporting. Those with an interest in business reporting who fail to join in the debate may find that they are left to implement what others decide.

1.2 Aims of this report

Over the past decade the Institute of Chartered Accountants in England and Wales (ICAEW) has been a major participant in efforts to improve the existing reporting model and to develop new reporting models. The ICAEW believes that the accounting profession should lead debate in this area and stake out common ground. That is why the ICAEW has decided that now would be a good time to do something different. Rather than issue further proposals for another even better new reporting model, why not take stock? This report is the result.

The report is aimed at an international audience of all those who are interested in the future of business reporting and it serves three main purposes:

1. to provide a cohesive summary of some of the key proposals for new reporting models in recent years, including some of the ICAEW's own work (Chapter 4);
2. to analyse the proposals from a change management perspective to offer new insights into the challenges they confront and to identify questions for discussion and research concerning the future of business reporting (Chapter 3); and
3. to identify fundamental issues so that the ICAEW can set priorities for further work and longer-term research in business reporting (Chapter 2).

1.3 Proposals for new reporting models

The greater part of the report is a summary of some of the key proposals for business reporting reform put forward over the past decade. The proposals are all characterised by their criticism of a traditional public reporting model in which historical financial statements play a central role. As the report addresses business reporting in general, and not specifically financial reporting, it does not look at the many proposals for fundamental reforms purely in financial reporting. Each of the proposals considered here puts forward a new reporting model for published information in which financial statements and related performance indicators are presented in a radically changed context.

The proposals selected demonstrate the strikingly wide variety of commentators who have taken an interest in this subject. They include academics, consultants, accountancy firms, professional bodies and other institutions, think tanks and investors. The selection is intended to be representative of the varied views that have been put forward and inclusion in this report should not be taken to indicate endorsement.

There is an unavoidable element of arbitrariness in choosing the contributions to include in such a summary, and failure to include a particular model should not be taken as any disparagement of its merits or importance. Not the least element of arbitrariness is the choice of a starting point. The proposals considered here date from the early 1990s onwards, but they did not emerge from nowhere and all owe debts to pioneering predecessors such as *Making Corporate Reports Valuable* (Institute of Chartered Accountants of Scotland (ICAS), 1988) and *The Corporate Report* (ICAEW, 1975).

Corporate performance is also subject to critical scrutiny from many investors who have a particular ethical or social viewpoint. The Social Venture Network in the US – to give just one example – brings together the views of a wide range of investors, and provides a valuable insight into their perspective on business conduct and reporting. The fact that such groups have not developed a distinctive reporting model does not mean that their viewpoints are irrelevant to the debate or that they are not reflected in some of the contributions that are considered.

The proposals considered here are set out in Table 1. A summary of each proposal appears in Chapter 4 of this report.

1.4 Scope of the report

Some of the proposals considered here are aimed primarily or exclusively at listed companies; others are aimed at business generally. It will sometimes be clear from what is said (e.g. references to rising share prices or stock market volatility) that parts of the discussion are only applicable to listed companies. But there is no merit at this stage in narrowing the discussion as a whole by excluding particular types of organisation.

Some of the proposals also look at how business reporting should be delivered, as well as at its content. While distinct in principle, the two issues of delivery and content are connected. Changes in information technology have made possible the rapid dissemination of large volumes of data, which can be accessed and analysed so as to meet different users' needs; this has implications for the content of that information. The focus of the report, and of this project, is primarily on the content of business reporting. But the IT aspects are highly relevant, and the ICAEW is pursuing in a separate project the contribution that digital technology, including XBRL (extensible business reporting language), could make to business reporting.

1.5 A framework for change

Those who propose new reporting models are calling for change, sometimes revolutionary change, in businesses' reporting practices. It is instructive to think about these proposals in the same way that you might think about any change management challenge, whether in business or public policy. The framework used here identifies seven issues for consideration.

1. **The problem.** Any reformer needs to present a persuasive analysis of how the current reporting model operates. How does it lead to bad decisions, actions and outcomes? If it ain't seen to be broke, nobody is going to be interested in fixing it.
2. **The solution.** In the present context, the solution will be a specific new reporting model with clear differences from the current model. Is it set out in a form that can be understood and implemented? Is there an explanation of how it will work and lead to better decisions, actions and outcomes?

Table 1: New reporting models for business

1. The Balanced Scorecard
The Balanced Scorecard: Translating Strategy into Action (1996; based on a 1992 article) – Professor Robert S. Kaplan and David P. Norton
2. The Jenkins Report
Improving Business Reporting – A Customer Focus (1994) – American Institute of Certified Public Accountants
3. Tomorrow's Company
Tomorrow's Company: The Role of Business in a Changing World (1995) – Royal Society of Arts and *Sooner, Sharper, Simpler: A Lean Vision of an Inclusive Annual Report* (1998) – Centre for Tomorrow's Company
4. The 21st Century Annual Report
The 21st Century Annual Report/Prototype plc (1998) and *Performance Reporting in the Digital Age* (1998) – both ICAEW
5. The Inevitable Change
Business Reporting: The Inevitable Change? (1999) – ICAS
6. Inside Out
Inside Out: Reporting on Shareholder Value (1999) – ICAEW
7. Value Dynamics
Cracking the Value Code: How Successful Businesses are Creating Wealth in the New Economy (2000) – Arthur Andersen
8. GRI
Sustainability Reporting Guidelines (2000; revised 2002) – Global Reporting Initiative™
9. The Brookings Institution
Unseen Wealth: Report of the Brookings Task Force on Understanding Intangible Sources of Value (2001) and Professor Baruch Lev's *Intangibles: Management, Measurement, and Reporting* (2001) – both Brookings Institution
10. ValueReporting™
The ValueReporting™ Revolution: Moving Beyond the Earnings Game (2001) and *Building Public Trust: The Future of Corporate Reporting* (2002) – both PricewaterhouseCoopers
11. The Hermes Principles
The Hermes Principles: What Shareholders Expect of Public Companies – and What Companies Should Expect of Their Investors (2002) – Hermes Pensions Management Limited

3. **The desired result.** The desired result is the reformer's vision of the outcomes that will result from adopting a new reporting model.
4. **Responsibilities.** Who will have to do what to make implementation of the new model happen?
5. **Motivation.** Why will those responsible for the proposed change want to adopt it? What will persuade them to act and, if they are not moved purely by an altruistic attraction to the desired result, what will be 'in it for them'?
6. **Practical difficulties.** What are the obstacles that will face those responsible for implementation? How will they be overcome in practice?
7. **Monitoring progress.** For any significant programme of change, it makes sense to monitor progress to see if the desired results are being achieved. In the light of experience and feedback, reformers should refine their analysis of problems, solutions, responsibilities, motivations and practical difficulties. Are the reformers prepared to do this?

Use of such a change management framework to analyse the proposals should not be taken to imply that the next step in this project is a refined set of proposals that will constitute 'the ultimate new reporting model'. This report's recommendations for further work are, on the contrary, put forward on the basis that a new reporting model with solutions to everybody's problems is not imminent. What is needed is a process of consultation, discussion, analysis and research that recognises the merits, as well as the limitations, both of what exists now and of the changes that are already taking place in business reporting.

In applying a change management framework to new reporting models that were not written with it in mind, there is a risk that some points in the proposals will not fall neatly under the headings. Problems of this kind have been encountered in preparing the summaries in Chapter 4, and it should be emphasised that the selection and arrangement of the material reflects the approach adopted in this report rather than the original authors'. There is a price to be paid in condensing some 2,000 pages of proposals into less than 50 pages, but also perhaps a benefit if more people are encouraged to read the original texts.

In Chapter 3, the framework presented above is used to make overall observations about the new reporting models, to identify challenges faced by their proponents and possible reasons for their limited success, and to identify detailed questions for discussion and research. Chapter 2 distils all the analysis that follows by listing six key underlying issues raised by the new reporting models of the past 10 years.

2. Underlying issues

2.1 The six issues

The analysis in this report, and the change management approach adopted here, show that there are six underlying issues on which there is deep disagreement between reformers and established opinion. Views on these issues, though firmly held, are often less firmly supported by evidence. They are therefore issues on which there is a need for research to establish facts and test arguments and for dialogue to bring different parties together to explore their differences.

1. Can business reporting serve multiple stakeholders?

No, according to the established view. Business reporting should be determined by the needs of investors, but fortunately there is a large overlap between investors' needs and other stakeholders'. Yes, say many reformers. Different stakeholders have different needs for information, but fortunately modern technology will allow multiple stakeholders to access precisely the information they want. (The *multiple stakeholders* question.)

The long-established view is that as investors are the owners of a business, how and what it reports should be determined by their needs. In recent decades attention to the importance and efficiency of capital markets has merely reinforced the same conclusion, though extending the meaning of investors to include potential investors. On this view, business reporting cannot reasonably be expected to meet the demands for different information that might come from other stakeholder groups.

However, the traditional focus of business reporting has been on the financial statements and in this area it is usually argued that investors' and other stakeholders' interests overlap. For example, an employee or a supplier who wants to understand the profitability and financial position of a business will need the same information for those purposes as an investor. But this overlap has not traditionally been viewed as extending to information outside the financial statements.

The reformers question the traditional view on two grounds. Some argue that there is an underlying long-term identity of interests among all stakeholders, and that therefore the supposed conflict between satisfying investors' needs and satisfying other stakeholders' needs is a false antithesis. Views differ as to whether this harmony of interests represents a change in the nature of business or a permanent truth, which has been overlooked. Other reformers agree that different stakeholders have different interests but argue that digital technology has made it feasible and cost-effective for businesses to gather all the information that all stakeholders might want. This can then be made available to stakeholders on an 'as needed' basis, using technology to layer and link information and offer pre-packaged information for different stakeholders.

2. Can business reporting meet all decision-making needs?

No, according to the established view. Business reporting plays an important role in investors' decisions but there needs to be recognition of the importance of other sources of information such as direct experience of the business or contact with management. Yes, say many reformers. They give reporting a more important and comprehensive role and attribute stock market volatility, bubbles and slumps to the alleged defects of today's reporting. (The *decision-making* question.)

It is important to know how important business reporting is to decision-makers. It is generally agreed that business reporting requirements should be determined on the basis of a cost-benefit test, and the greater business reporting's contribution to decision-making, the greater the extent of the disclosures that can be justified. If you accept the

view that inadequate reporting is to some extent responsible for the volatility of the stock market, then you might well conclude that very extensive new disclosures and/or more frequent ones would be justified if they could mitigate the problem.

Against this, there is a view that business reporting plays a more modest part in decision-making. Other sources of information – such as personal contact with management, direct experience of the business and the opinions of third parties – are often more important and the gyrations of stock markets have profound behavioural and institutional causes that no amount of business reporting could ever eliminate.

3. Can business reporting depend on the invisible hand?

No, according to the established view. Ultimately, regulation drives progress, not self-interest and market forces. Without regulation there is no comparability and bad reporting drives out good. Yes, say many reformers. Change imposed by regulation results in token compliance and boilerplate rather than useful information. Improvement can and should be left to market mechanisms. (The *invisible hand* question.)

Business reporting in recent decades has been shaped largely by the requirements of legislators, securities regulators and accounting standard-setters. The argument for this approach is essentially that there is no other effective way of ensuring that reporting is comparable and meets users' needs.

A number of the reformers take a different view. They argue that regulation-led disclosure cannot be guaranteed to meet users' needs, that it is unable to cope with the diversity of business, and that it leads to reporting that is an exercise in compliance rather than communication. They suggest instead that any new reporting model should be implemented by a four-stage process of (i) individual companies pioneering new practices, (ii) others gradually copying these as best practice, (iii) best practice becoming codified in non-mandatory form, and (iv) the regulators finally reflecting best practice in mandatory requirements. Those who support this approach are able to give historical examples of instances where practice has been changed in this way.

This line of argument recalls a famous passage in Adam Smith's *The Wealth of Nations*. Discussing the behaviour of entrepreneurs, Smith argues that the individual 'intends only his own gain, [but] he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention' – one that 'promotes the public interest'. For business reporting, the argument is that the interaction of individual companies pursuing their own self-interest and individual investors pursuing theirs produces improved disclosure practices that benefit the market, and society, as a whole.

There are important assumptions on both sides of the debate. The regulatory approach assumes that companies' self-interest alone cannot produce the beneficial public goods that will be created by standardised disclosures. The 'invisible hand' approach assumes that the market will reward improved disclosure with a lower cost of capital and correspondingly punish companies that fail to comply with emerging best practice. So for business reporting Gresham's Law has to be stood on its head: good reporting drives out bad.

4. Can business reporting benefit from a new conceptual framework?

No, according to the established view. The existing conceptual framework of the accounting standard-setters is perfectly adequate. Yes, say many reformers. The framework needs to be developed to reflect the needs of all stakeholders for

non-financial and forward-looking information, and the importance of intangibles.
(The *conceptual frameworks* question.)

The accounting standard-setters' conceptual frameworks (summarised in the Appendix to this report) are restricted to financial statements. They concentrate on investors' needs, on what is historical, on what can be quantified in monetary terms and what can be reliably measured. The reformers argue that there is a large volume of information that would be useful to various stakeholders that is forward looking, non-monetary, qualitative rather than quantitative, and in some cases perhaps not reliably measurable. To have a sensible framework for deciding what information of this sort businesses should disclose there is a need to extend or to go beyond what exists already.

Against this, there is some scepticism about the alleged deficiencies of existing financial reporting and therefore doubts about how strong the case is for radically new forms of business reporting or a new framework to support them.

5. Can business reporting attach values to all intangibles?

No, according to the established view. Intangibles are nothing new and existing management and reporting techniques can cope with them. Yes, say some of the reformers. The rise of intangibles has changed the modern economy and only radical changes in reporting will enable businesses to respond appropriately.
(The *intangibles* question.)

In some ways this is simply a debate about how much the world has changed, with one side emphasising the continuities and the other the discontinuities between past and present. There is no doubt that business activity has been transformed in the past generation and that such intangibles as skills, knowledge and relationships are central to that transformation. However, it is at least arguable that in developed economies the same could be said of every generation for the past 250 years and some would go back even beyond that. So is the importance of intangibles something new and is this really the kind of sea change in the nature of business that requires a corresponding change in reporting?

Some of those who argue that there has been a dramatic change in the nature of business, and that reporting therefore needs to undergo an equally dramatic change, specify that businesses can and must disclose and even value all their intangibles. Traditionalists would argue that, even supposing this is desirable in principle, it is impossible to do sensibly in practice.

6. Can business reporting achieve transparency?

No, according to the established view. Transparency in business reporting is significantly constrained by considerations of cost, competition, confidentiality and litigation. Yes, say many reformers. There should be almost no limits on transparency. (The *transparency* question.)

While everyone agrees that transparency is a good thing in principle, there is usually also some recognition that there are practical limits to it. Against this, some argue that the constraints are generally overstated and are often little more than self-interested excuses for non-disclosure. On this view, there is no good reason why businesses should not be genuinely transparent.

2.2. The way ahead

The answers to each of these questions will affect in varying degrees the answers to the other five. They therefore need to be considered in parallel and as parts of a single, coherent project.

On all six of these fundamental issues the ICAEW will work at a national and international level with interested parties to invite views, host discussions and encourage research. The purpose is not to force acceptance of a new reporting model that has already been decided on, but to facilitate agreement on whether a new model is needed, what it might look like and how it should be promoted.

In particular, the ICAEW wishes to facilitate international moves to improve statements such as the OFR and MD&A. Many advocates of new reporting models see this as fertile ground for their ideas. However, the analysis in this report suggests that success will depend upon deep-rooted beliefs – beliefs about the extent to which business reporting can serve multiple stakeholders, meet decision-making needs, rely on the invisible hand, benefit from an expanded conceptual framework, attach values to intangibles and achieve transparency.

The ICAEW is in a unique position to act as a facilitator in this process. Its members around the world are involved in every aspect of business and reporting. They play key roles on company boards, prepare internal and external reports, perform audits, act as investment analysts, take investment decisions as managers, entrepreneurs and investors, and work as regulators and standard-setters.

More detailed questions for further work, arising from the change management approach adopted in this report, are developed in Chapter 3. It is indicated there which of the six underlying issues each one most closely relates to.

3. Analysis and questions

3.1 Problems

The advocates of new reporting models recommend huge changes, both in the information that companies collect and in the public disclosure of the information they use internally. Such revolutionary changes can only be justified if there is a huge problem that needs to be solved. Some of the reformers describe problems that do indeed appear to match the scale of the proposed remedy. *Building Public Trust* puts the point forcefully: 'Every aircraft in the world would be grounded if air traffic control relied on the same type of system that companies use today to report their information.' *The ValueReporting™ Revolution*, *Unseen Wealth*, and *Intangibles: Management, Measurement, and Reporting* all contain forceful analyses of how the reporting system malfunctions.

The 11 proposals considered here claim to identify a range of inherent limitations in traditional financial reporting:

- It simply does not address a broad enough range of users' needs. Standard-setters claim that the financial information needed by investors will generally meet the needs of other users. But the financial disclosures mandated for the benefit of investors clearly do not meet the demands made on behalf of all the stakeholders whose interests are espoused by GRI, for example.
- In reporting historical financial performance, financial statements focus on lagging indicators and not leading non-financial indicators of future financial success. Even reformers who support the traditionalists' interest in investor needs argue that investors are poorly served by financial statements. Every proponent of a new reporting model makes this allegation, although it is the Jenkins Report and the Inevitable Change that argue most robustly that investor needs are not properly addressed.
- Traditional financial reporting's criteria for recognition of assets, which are based on reliability of measurement, preclude the recognition of the intangible relationship and knowledge assets on which modern business depends. This fundamental criticism is made strongly by most reformers and prompts radical calls by Value Dynamics and the Brookings Institution for a new approach to asset recognition and measurement.
- Traditional reporting encourages managers, investors, analysts and commentators to focus on summary earnings numbers, which compound all the other inherent limitations referred to above, and to take a short-termist approach. This is the particular focus of *The ValueReporting™ Revolution* with its call to end the earnings game.
- The cumulative effect of all the alleged defects of traditional financial reporting is that there is said to be a yawning gap between managers' information about a business (and therefore their opinion on its value and prospects) and the information available to investors and other stakeholders (and therefore their assessment of the business). This gap is a common theme that is particularly emphasised by Inside Out and it creates pressures for undesirable privileged access to information for key investors, as is noted by the 21st Century Annual Report and the Inevitable Change.

So one might assume that there has been a massive misallocation of resources, both by companies and their investors, with neither external investors nor other stakeholders knowing where they ought to put their money or their trust.

Moreover, if one accepts the critics' conclusions, there appear to be some major deficiencies in the very foundations of financial reporting that call for radical analysis. After all, the conceptual frameworks that underpin all major bodies of accounting

standards claim to have as their objective the provision of useful information for decision-making. The Appendix to this report looks at the conceptual frameworks and identifies some of the gaps between their approach and those of the reformers.

But anyone who asked to see evidence that the current financial reporting model, unchecked by other decision-making mechanisms, had caused major resource misallocation, might be disappointed. Most of the reformers also show little appetite for the heavy work needed to revisit and extend the conceptual frameworks of the accounting standard-setters or to develop alternatives.

Consequently, the following questions merit consideration by researchers and wider public discussion. Throughout this chapter, it is suggested in brackets after each question to which of the six underlying issues it relates most closely.

1. How far do different stakeholders' information needs overlap? (*Multiple stakeholders*)
2. What evidence is there of misallocation of resources in the recent technology boom and to what extent, if at all, can this be attributed to shortcomings in the traditional financial reporting model rather than to other factors? (*Decision-making*)
3. Do criticisms of traditional financial reporting highlight the need for a broader framework for business reporting and call into question central tenets of standard-setters' conceptual frameworks (e.g. the users of information, focus on financial statements, and criteria for recognising assets)? (*Conceptual frameworks*)
4. How do managers and external investors actually take investment decisions in the absence of any significant financial statement information (e.g. for a technology start-up where all expenditure has been expensed)? (*Intangibles*)
5. What information do managers use to take resource allocation decisions when they are not constrained by financial reporting conventions and what information do external investors require when they are in a position to impose private reporting requirements? What would be the benefits and dangers of publicly reporting this information? (*Transparency*)

3.2 Solutions

The solutions on offer in the form of new reporting models comprise different mixtures of the following elements.

- Suggested structures for annual reports that give reduced prominence to the financial statements or extracts from them. Such structures or templates provide the context in which financial statement information should be understood. They deal with topics such as strategy, markets, value drivers, KPIs, risks, management and so on. Particularly detailed templates are provided in the Jenkins Report, Tomorrow's Company, Inside Out and ValueReporting™.
- Blueprints for new corporate databases accessible via the internet, which not only contain the traditional and new types of information envisaged by others but also utilise technology to layer and link information, provide access to external sources, offer pre-packaged information for different stakeholders and allow online dialogue with management. There is a strong emphasis on technology in the 21st Century Annual Report, the Inevitable Change, Value Dynamics and Value Reporting™.

- Encouragement to managers to articulate a model of how their business creates value so that they can report this externally and identify value drivers and related KPIs that will also be reported externally as well as internally. Inside Out and ValueReporting™ are particularly clear on this topic and the latter advocates the identification of quantified relationships between indices of value drivers, such as product quality, and shareholder value, via financial measures such as sales value.
- Calls for industry groupings to establish standardised KPIs, as in the case of ValueReporting™.
- The development of groups of KPIs, for example by business process or objective, from which companies can select those relevant to them, as in the case of GRI.
- Promotion of more ambitious classification schemes and frameworks for describing modern businesses with their reliance on relationship and knowledge assets, including programmes for developing new measures for intangible assets, which will ultimately support the inclusion of new values in financial statements. The Balanced Scorecard, Value Dynamics and the Brookings Institution are all keen to establish new vocabularies for business. The idea of the 'triple bottom line' as a way of analysing the economic, environmental and social impacts of a business – introduced by John Elkington in *Cannibals with Forks: The Triple Bottom Line of 21st Century Business* – is built on by GRI. New measures for intangible assets are the declared ambition of Value Dynamics, but the Brookings Institution in particular develops specific proposals for obtaining them.

The proponents of the new models are aware of certain difficulties that they face in putting their models into practice. The more ambitious and prescriptive they are, the less likely they are to attract immediate support. However, looser recommendations run the danger of what *Unseen Wealth* describes: 'hundreds of thousands of snippets of information that firms might selectively, and on their own initiative, provide to investors But such information is just fog if it is not reported regularly and collected in a consistent and sensible way'.

Sceptics faced with choices about what to report and whether to 'do their own thing' or opt for a proprietary template or menu of KPIs might expect proponents of new reporting models to offer more evidence that their proposals support improved decision making.

There are also tensions between the reformers' advocacy of online dialogue between companies and any third party and the standard-setters' presumption that users of general purpose financial statements have no opportunity to interact with the statements' preparers.

Further topics for informed discussion and research might include the following:

6. To what extent is it practical or cost-effective for corporate databases to meet the divergent needs of different stakeholders? (*Multiple stakeholders*)
7. Which KPIs have, with the benefit of hindsight, represented good predictive indicators of business performance and value? (*Decision-making*)
8. Is the case for light-touch regulation and principles-based standards either more or less persuasive in new areas of reporting? (*The invisible hand*)
9. What are the limits of measurement and is it right to focus only on what is measurable, including KPIs, or is some information better communicated in words? (*Conceptual frameworks*)

10. To what extent, if at all, does interactive web technology undermine a central presumption of the standard-setters' conceptual frameworks, that users have no ability to interact with preparers of general purpose financial statements? (*Conceptual frameworks*)
11. What are the general principles for presenting information in a meaningful hierarchy so that users, whether they are online or not, are presented with the most significant information first and are not misled if they fail to drill down deeper? (*Conceptual frameworks*)
12. What are the practical limits and benefits of modelling an individual business to identify value drivers and relationships that should be reported given the elusive nature of value and the pace of change that affects all businesses? (*Intangibles*)
13. Do the internal and external users of business reports understand and find useful information that is based on complex valuation models (e.g. for certain intangibles) and potentially volatile market prices? (*Intangibles*)

3.3 The desired result

All the reformers envisage many if not most of the following outcomes from the implementation of their new reporting models:

- improved long-term business performance;
- better relations with investors and other stakeholders founded on greater mutual understanding and fairness and, to be more technical, reduced agency problems and information asymmetry;
- consequential reductions in share price volatility and the cost of capital;
- enhanced value creation (i.e. higher share prices); and
- more efficient resource allocation.

In the case of GRI in particular these identified benefits have an added dimension in that they should not be interpreted purely in terms of shareholder value. The information provided under GRI is also intended to help decisions to take account of wider economic, environmental and social impacts.

Given the scale of the changes in external reporting that reformers are demanding, their articulation of the benefits could be more compelling; for example, they do little to explain complex abstract concepts such as the cost of capital and capital market efficiency. However, some of the attempts to try and bring the benefits down to a personal level, for example in terms of real-time online access to ever changing information, may intimidate more people than they excite.

A sceptic is surely entitled to ask for harder evidence of the potential benefits. The cost of capital is perhaps the easiest of the predicted benefits to look at systematically. The US Financial Accounting Standards Board (FASB)'s *Improving Business Reporting: Insights into Enhancing Voluntary Disclosures* provides a useful summary of the limited research on this point, which does indeed show that improved disclosure tends to lead to a lower cost of capital. But in *Intangibles: Management, Measurement, and Reporting*, Professor Lev, who supports the cost-of-capital argument, comments that 'In reality, there is still only scant

evidence of a link between improved disclosure and cost of capital, and the estimated reduction in cost of capital is very modest.’

Therefore, just some of the questions that might be asked are:

14. How might you go about quantifying the potential of new reporting models either to improve business performance or to help investors recognise value? (*Decision-making*)
15. To what extent are share price volatility and stock market cycles attributable to shortcomings in the usefulness of business reporting rather than to factors such as underlying economic cycles, inherent uncertainty and herd-like behaviour patterns? (*Decision-making*)
16. What are the linkages between financial and triple bottom line reporting on the one hand and improved economic, environmental and social sustainability on the other and how might the impact of reporting be measured? (*Decision-making*)
17. How cost-effective is business reporting reform as a way of securing improvements in value creation or sustainability, compared for example to education or changes in management practice, governance or regulation? (*Decision-making*)

3.4 Responsibilities

Every reformer assigns important if not exclusive responsibilities for implementing new reporting models to managers of businesses. Of course, managers are the only people who can actually implement the models. But what is remarkable is that they are also believed to have the power to lead the charge and make fundamental change happen.

While many, including the proponents of Tomorrow’s Company, the Inevitable Change, Value Dynamics and ValueReporting™, issue calls to action to other parties in the corporate reporting supply chain, it is only the Jenkins Report and the Brookings Institution that give any significant billing to government and regulators, notably the United States Securities and Exchange Commission (SEC) and FASB. ValueReporting™ is openly hostile to the premature involvement of government and regulators.

Managers of companies can be expected to resist the presumption that they have the main responsibility for implementation. Others might also challenge the wisdom of placing so much reliance on such a numerous, diverse and dispersed group. Revolutionaries might end up by relying on a mass uprising to secure their ends, but it is also worth exploring more direct solutions.

While it could be difficult to move regulators of company reporting without evidence of widespread business support, there may be alternatives. For example, institutional investors have considerable power over companies and yet are widely seen by the supporters of new reporting models as being indifferent to their adoption. The Hermes Principles reflect a different approach under which investors could set out their own expectations for expanded and innovative reporting.

It might be more effective for the reformers to mobilise a relatively small number of powerful institutional investors. If all else failed, the supporters of reform could even ask the authorities that regulate such investors to insist on higher standards of dialogue with companies based on the broad agenda of the models. After all, investors should be working to build the value of their investments.

The following further questions appear to merit more general discussion and possibly detailed research:

18. Some reformers advocate a phased approach in which experimentation by a few companies is followed by widespread voluntary adoption, then by compliance with best practice codes by the majority of companies, and finally by mandatory requirements set by regulators. What persuasive and relevant precedents are there to support this approach, and are certain institutional arrangements and power structures common to markets where it appears to work? (*The invisible hand*)
19. Is it appropriate and realistic to expect securities regulators and accounting standard-setters to make use of their power to take on significant responsibilities for innovation in reporting? (*The invisible hand*)
20. Would it be feasible and efficient to promote adoption of new reporting models through intermediaries such as institutional investors or suppliers of business reporting software? Are there persuasive precedents for this type of innovation to be led by powerful market players? (*The invisible hand*)

3.5 Motivation

Most of the reformers place the responsibility for instigating change on the shoulders of managers in the belief that they have the power to make things happen. However, this raises the bigger question of whether managers will see enough for themselves in the new models to make it worth their while to instigate change. Though it is appealing to think that responsibility and motivation will coincide, it would be optimistic to assume that they do. Busy managers are generally unlikely to give priority to introducing a new reporting model simply because its adoption would satisfy a wider range of stakeholders or promote more efficient capital allocation or a lower cost of capital.

The Brookings Institution provides detailed and realistic assessments of why managers might not enthusiastically embrace any of the new reporting models. Why commit to any voluntary expanded disclosure if it could bite you in future? Why give up a regime in which investment in intangibles is written off as an expense and managers are less likely to be held to account for the return on that investment? Why be a first mover in an activity that requires a critical mass of devotees if it is to deliver substantial benefits?

Nevertheless, while all the reformers admit the problems, they still attribute a crucial role to volunteering managers, even when, like the Jenkins Report and the Brookings Institution, they see a role for government and regulators. This is despite the 'public goods' problem that the benefits to a single company of its adopting a new reporting model may be limited. For example, the market may not know what to make of the disclosures unless other companies are making similar ones.

Some models, including the Brookings Institution and ValueReporting™, set out sophisticated market mechanisms that will achieve voluntary adoption of standards. These mechanisms rest essentially on the benefits to a company of making disclosures that others do not make. However, it is unclear why market mechanisms that have not achieved standardisation in current areas of reporting will do so in the future, and what changes are required to make the transition from a position where market mechanisms do not achieve standardisation to one in which they will.

Reliance on voluntary action by managers is likely to provoke scepticism and raises additional points for discussion and research along the following lines:

21. Even if in certain circumstances the market can effect the adoption of high quality standards that promote the public interest, would it be clearer and more efficient to have a regulator exercising its authority to promulgate standards and enforce their consistent adoption? (*The invisible hand*)
22. What are the implications for business reporting of economic analysis of situations where the unco-ordinated actions of individuals and businesses are unable to secure the creation of public goods from which all would benefit? (*The invisible hand*)

3.6 Practical difficulties

All the advocates of change recognise obstacles that will need to be faced by those responsible for implementing new reporting models. Where they are unable to provide practical and convincing answers, they generally trim the demands of the model. Practical difficulties arise in five major types of situation:

- When a model might appear to demand the publication of information that management would not otherwise produce for internal purposes. The Jenkins Report and Inside Out would immediately conclude that such information should not be disclosed. Although there is an argument for this conclusion, it provides an apparent escape clause for the unscrupulous.
- Where commercial sensitivity comes into conflict with the spirit of transparency. This is a pervasive concern, but the 21st Century Annual Report, Inside Out and ValueReporting™ pay particular attention to it. Once again there is grudging acceptance of the need to permit companies to protect their own interests, but wariness about encouraging boilerplate excuses.
- When it can be argued that directors and managers would be exposed to undue risks of litigation and personal liability under national laws as a result of making a disclosure. This concern seems to push whole categories of prospective information off limits or to require the reformers to make liability reform a regulatory precondition for requiring full implementation of their models, as in the case of the Brookings Institution. The danger is that liability will be used as a pretext for avoiding any future-orientated disclosure that might put management at risk of embarrassment. To counter this, the ICAEW has performed extensive work in recent years to demonstrate how practical and responsible approaches can be taken to reporting on the future, notably in *No Surprises: The Case for Better Risk Reporting* (1999) and *Prospective Financial Information: Guidance for UK Directors* (2003).
- Where disclosures might lack credibility in the absence of some form of auditor assurance. The Jenkins Report, the Inevitable Change, GRI and ValueReporting™ identify the opportunities for new forms of independent assurance without getting into the detail of what this might involve or dwelling on the decade-long struggle of the International Auditing Practices Committee and its successor, the International Auditing and Assurance Standards Board (IAASB), to produce the necessary standards.
- In a variety of practical circumstances where existing systems, national regulatory reporting requirements or lack of tools or experience prevent a company from delivering what a model requires. GRI and Value Dynamics are keen to emphasise the need for some flexibility and patience to allow companies to adapt and learn.

While it is clearly appropriate to recognise practical difficulties, this has disadvantages if it appears to allow managers to disclose nothing extra yet still claim to comply with a new reporting model.

For the models themselves to be credible there seems to be an urgent need for clear, principled thinking and properly grounded research to address the following issues:

23. What, if any, are the limits on the types of information on which auditors can provide reasonable assurance and report publicly, and will auditor reporting that meets the needs of investors and others emerge through market forces or will significant regulatory intervention be needed? (*The invisible hand*)
24. Will it be possible to reach international agreement on principles for when and how prospective financial information should be prepared and published that will allow preparers to respond directly to users' interest in future cash flows without increasing their vulnerability to legal liability? (*Conceptual frameworks*)
25. What has been the practical experience of companies that have implemented new reporting models? What information have they not reported because it was of no perceived benefit internally or because they could not overcome problems caused by legacy systems, regulatory reporting requirements, lack of tools and experience, cost or risk? (*Transparency*)
26. Can acceptable but tough criteria be developed to justify disclosure exemptions on grounds of commercial sensitivity, for example by reference to non-disclosure being in the interest of the users who are being denied the information? (*Transparency*)

3.7 Monitoring progress

In making any fundamental changes, it is sensible to monitor progress and to modify plans in the light of experience. GRI and ValueReporting™ provide excellent examples of organisations that are committed to monitoring progress and publicising it. The format of GRI's guidelines also allows it to update them regularly in the light of experience, but this is unusual. There are two problems here:

- Most of the proposals for reform are, reasonably enough from the point of view of their authors, intended to set out definitive statements of what needs to be done. The reformers do not generally regard themselves as being accountable for implementing or failing to implement the changes they advocate. However, this leaves them in the high-and-dry position of issuing calls to action and waiting for a response. This is not a criticism of the authors; it is simply an inevitable result of writing something that calls on others to make changes.
- With the exception of GRI, the proposals have no built-in mechanism for measuring changes in reporting practices and responding to the lessons of experience. This does not invalidate any of the proposals, but it may reduce their effectiveness.

It might be unfair to treat the reformers as managers and hold them to account for whether their proposed changes have been implemented. However, viewing the proposals through a change management lens does raise some interesting questions for discussion and research:

27. How might you monitor progress in addressing the problems and reaching the outcomes sought by the reformers and, instead of merely ticking compliance with a list of proposed disclosures, establish the changing contribution of business reporting to efficient resource allocation and value creation? (*Decision-making*)
28. Would it be possible to establish a generally accepted method for measuring changes in business reporting, so that managers, stakeholders, standard-setters, regulators and future reformers could better understand the effectiveness of regulatory and other mechanisms for bringing about change? (*The invisible hand*)

4. Proposals for reform

The analysis in the preceding chapters is based on a study of proposals made in recent years for new reporting models for business. This chapter provides summaries of the eleven key proposals listed in Table 1 using the change management framework set out in section 1.5.

4.1 The Balanced Scorecard

The Balanced Scorecard reports performance not just from a financial perspective, but also from a customer perspective, a business process perspective and a learning-and-growth perspective.

The Balanced Scorecard – Measures that Drive Performance, an article by Robert S. Kaplan and David P. Norton, appeared in the *Harvard Business Review* in 1992. The authors expanded their ideas in a 1996 book, *The Balanced Scorecard: Translating Strategy into Action*. The two works are broadly consistent, and what follows quotes from both of them, but mainly from the latter. The Balanced Scorecard is one of the most influential management ideas of the past 15 years. For that reason, it may seem surprising to include it in a study on external reporting. However, as Kaplan and Norton make clear, the background to their thinking is dissatisfaction with the current external reporting model, and they argue – in their 1996 work – that their management techniques should lead to changes in external reporting.

The linkage between the Balanced Scorecard and external reporting has also been acknowledged in other calls for change. For example, *Measures that Matter*, issued by the US accounting firm of Ernst & Young in 1997, urges companies to disclose more non-financial measures and acknowledges that the kind of information in question is what one would find in balanced scorecard systems.

4.1.1 The problem

The authors explain that the scorecard was developed in a 1990 study ‘motivated by a belief that existing performance-measurement approaches, primarily relying on financial accounting measures, were becoming obsolete. The study participants believed that reliance on summary financial-performance measures [was] hindering organizations’ abilities to create future economic value.’

According to Kaplan and Norton, ‘The financial-reporting process remains anchored to an accounting model developed centuries ago for an environment of arm’s-length transactions between independent entities. This venerable financial accounting model is still being used by information age companies as they attempt to build internal assets and capabilities, and to forge linkages and strategic alliances with external parties... Ideally, this accounting model should have been expanded to incorporate the valuation of a company’s intangible and intellectual assets, such as high-quality products and services, motivated and skilled employees, responsive and predictable internal processes, and satisfied and loyal customers... Realistically, however, difficulties in placing a reliable financial value on such assets ... will likely preclude them from ever being recognized in organizational balance sheets. Yet these are the very assets and capabilities that are critical for success in today’s and tomorrow’s competitive environment.’

‘Financial measures tell the story of past events, an adequate story for industrial age companies for which investments in long-term capabilities and customer relationships were not critical for success. These financial measures are inadequate, however, for guiding and evaluating the journey that information age companies must make to create future value through investment in customers, suppliers, employees, processes, technology, and innovation.’

Kaplan and Norton associate financial measures with the short term. They point out that ‘the pressure for short-term financial performance can cause companies to reduce spending on new product development, process improvements, human resource development, information technology, data bases, and systems as well as customer and market development. In the short run, the financial accounting model reports these spending cutbacks as increases in reported income, even when the reductions have cannibalized a company’s stock of assets and its capabilities for creating future economic value. Alternatively, a company could maximize short-term financial results by exploiting customers through high prices or lower service. In the short run, these actions enhance reported profitability, but the lack of customer loyalty and satisfaction will leave the company highly vulnerable to competitive inroads.’

The authors’ principal criticism of financial measures – apart from their historical nature and their association with short-termism – is their failure to capture intangibles. They argue that ‘the ability of a company to mobilize and exploit its [intangible] or invisible assets has become far more decisive than investing and managing physical, tangible assets’ and that ‘information age companies will succeed by investing in and managing their intellectual assets.’

4.1.2 The solution

The central idea of the Balanced Scorecard is that managers should develop the measures on which they manage the business from four different perspectives:

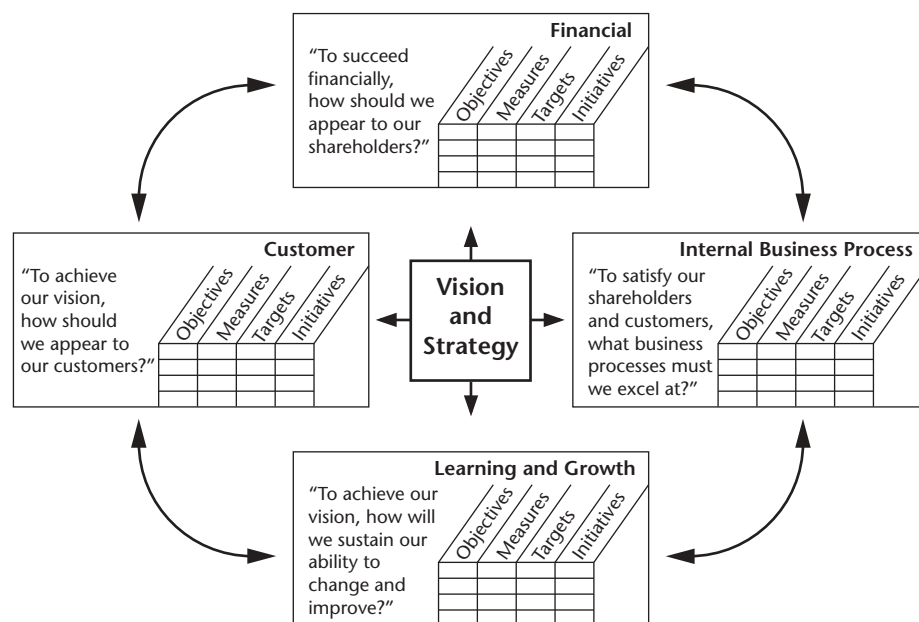
- customer (‘how do customers see us?’) – e.g. on-time delivery
- internal business process (‘what must we excel at?’) – e.g. manufacturing cycle time
- learning and growth (‘can we continue to improve and create value?’) – e.g. time to market for new products
- financial (‘how do we look to shareholders?’) – e.g. operating income by division.

The measures on the scorecard should be a mixture of ‘outcome measures’ and ‘performance drivers’.

Kaplan and Norton envisage that the scorecard, although primarily a management tool, should also become a basis for external reporting.

Figure 1 summarises the ideas of Kaplan and Norton:

Figure 1: The Balanced Scorecard



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4.1.3 The desired result

Kaplan and Norton emphasise that the outcome of successful strategies that use the balanced scorecard for internal reporting must be improved long-term financial performance. The scorecard, because it gives equal prominence to the relevant non-financial measures, should discourage the short-termism that leads to cuts in spending on new product development, human resource development, and so on, when such cuts are not in the long-term interests of the business. The different measures on the card do not embody trade-offs, however, but are rather 'a series of cause-and-effect relationships' because 'investments in employee re-skilling, information technology, and innovative products and services... [will] dramatically improve future financial performance.' Adoption of the scorecard internally will therefore lead to improved performance by focusing managers' attention on measures of intangibles that would otherwise be neglected.

The authors also suggest that 'To gain maximum benefit [from the scorecard], the executive team should share its vision and strategy with the whole organization, and with key outside constituents.' Use of the scorecard for external reporting will create 'a shared understanding and commitment among all organizational participants.'

4.1.4 Responsibilities

As the scorecard used internally is a management tool, it is managers' responsibility to devise and implement it. Every company is different and needs to work out for itself what scorecard measures are appropriate for it. 'Measures chosen by even excellent companies for their own strategies are unlikely to be appropriate for other organizations that face different competitive environments, with different customers and market segments, and in which different technologies and capabilities may be decisive.'

As the scorecard used externally is also essentially a management tool, it is again managers' responsibility to decide what should be disclosed and how any problems of confidentiality can best be overcome.

4.1.5 Motivation

The balanced scorecard is primarily a management tool, so the motivation to use it has to come from managers. They will want to use it internally, Kaplan and Norton envisage, because they can see that concentration solely on financial measures is damaging the business by leading to short-termism and neglect of the intangibles that will create future success.

As far as external reporting is concerned, the motivation again has to come from managers. The authors conclude that: 'the best financial reporting policies will eventually be derived from the best internal reporting policies... As senior executives become more experienced and confident about the ability of scorecard measures to monitor strategic performance and predict future financial performance ... they will find ways to communicate these measures to outside investors, without disclosing competitively sensitive information.'

Kaplan and Norton concede that investors are apathetic about the kinds of measures that appear on the scorecard, so they do not expect any pressure from that quarter to adopt it in external reporting. Managers, on the other hand, will see the advantages of using the scorecard as an external communications tool to ensure that those with whom the business has relationships understand what it is trying to achieve and are therefore working with the business towards a common goal. The outside audiences being addressed include investors.

The Ernst & Young report referred to above is however less pessimistic about the motivation of investors and notes that there is 'a growing body of evidence revealing that reliance on financial measures alone will critically undermine the strategies leading-edge companies must pursue to survive and thrive long term... Through strategic performance measurement or balanced scorecard systems, [smart companies] are gathering critical non-financial data to help pinpoint problems, improve processes and achieve organizational goals... But more importantly, companies are starting to realize the value outside stakeholders are placing on this information... *Not only do non-financial measures matter to corporate executives, but more importantly ... investors take these measures into account when valuing companies...*'

Ernst & Young conducted research into what investment analysts paid attention to and found that 'Non-financial criteria constitute, on average, 35% of the investor's decision.' 'Companies that fail to tell the market about their [non-financial] performance leave investors to make their own inferences. They may underestimate corporate performance, thus undervaluing the stock, or they may overestimate it, which means severe penalties when forecasts are adjusted... Corporate managers who ignore the benefits of measuring and managing non-financial data may unwittingly be contributing to the undervaluation of their companies. Moreover, they may be handicapping their company's ability to attract new investment capital, particularly if their competitors do measure and provide such data.' The three non-financial 'metrics' that the E&Y study found to be of most importance to investors were: strategy execution, management credibility, and quality of strategy.

4.1.6 Practical difficulties

Kaplan and Norton's main interest is in the implementation of the balanced scorecard for internal use, and they identify several reasons why scorecard projects sometimes fail:

- Managers mistakenly think that because they already use non-financial performance measures, they already have a balanced scorecard.

- Senior executives misguidedly delegate scorecard implementation to middle managers.
- Businesses try to use the best measures used by the best companies, rather than developing their own.
- Businesses try too hard for perfection.
- Senior executives wrongly think that the scorecard is just about reporting; in fact, it is a new way of managing the business.

While these difficulties refer to the internal use of the scorecard, unless it is used internally successfully, it won't be used as a basis for external reporting.

Kaplan and Norton recognise that there are constraints and disincentives that apply specifically to external reporting. 'Historically, companies have been reluctant to disclose information beyond the minimum required by regulatory authorities... First, executives are properly concerned that anything beyond minimal disclosure could benefit competitors more than existing shareholders. Especially if the Balanced Scorecard is a clear articulation of business unit and corporate strategy, its public revelation could enable competitors to sabotage a well-formulated and executed strategy.'

'A second concern is with liability... By voluntarily communicating the scorecard, managers fear that failure to achieve or improve on these ... measures could become the basis for shareholder suits...'

'A third reason comes from the apathy of much of the investment community about nonfinancial information, especially when that information explicitly communicates long-term goals... If financial analysts remain indifferent to measures of a company's long-term strategy, we are not optimistic that Balanced Scorecard reporting will become part of an organization's communication program to outside shareholders.'

4.1.7 Monitoring progress

The authors do not appear to have monitored the use of the scorecard as a basis for external reporting. Recently, however, they have launched a subscription newsletter, *Balanced Scorecard Report*, giving information on balanced scorecard implementation by businesses.

4.2 The Jenkins Report

The Jenkins Report proposes a comprehensive model of business reporting, in which the financial statements would form just one element, designed to meet the needs of the providers of finance for business.

Improving Business Reporting – A Customer Focus, generally known as 'the Jenkins Report', was published by the American Institute of Certified Public Accountants in 1994. It was prepared by a committee set up in 1991 and chaired by Ed Jenkins (later chairman of the US Financial Accounting Standards Board). The committee undertook extensive surveys of users' needs (restricted to investors and creditors and their advisers) 'to identify the types of information most useful in predicting earnings and cash flows for the purpose of valuing equity securities and assessing the prospect of repayment of debt securities or loans.' In the report itself, the needs of those who value equity securities receive greater attention.

4.2.1 *The problem*

The Jenkins Report notes ‘concerns about the relevance and usefulness of business reporting’ and that businesses are developing new performance measures, including non-financial ones. ‘Business reporting,’ it says, ‘must keep up with the changing needs of users or it will lose its relevance’. However, the report also says that ‘the Committee’s study confirmed the importance of financial statements. Financial statements generally provide users with essential information that heavily influences their decisions. There is no evidence that users are abandoning analyses of financial statements because they believe the information is irrelevant or for other reasons.’ It found, though, that users were ‘strongly critical of certain aspects of financial reporting’.

The report goes into users’ criticisms of financial reporting in some detail. The key points are:

- ‘Users ... believe that many companies define segments too broadly for business reporting and thus report on too few industry segments.’
- ‘Users complain that companies too often do not report enough information about investees.’
- ‘Accounting standards have not kept pace with the proliferation of innovative [financial] instruments. As a result, users are confused. They complain that business reporting is not answering important questions...’
- ‘Users are concerned that they do not understand the risks resulting from certain transactions and arrangements that, under current accounting rules, are not reflected on the balance sheet.’
- ‘Users are concerned that current rules may permit companies to exclude from their balance sheets rights and obligations that make companies appear to be less risky than they are.’
- ‘Users believe that financial statements and related disclosures do not contain sufficient information about unusual or non-recurring items...’
- ‘Users ... suggest that current disclosures about the imprecision of measurement [of assets and liabilities] are not adequate...’

It could be argued that this long list of criticisms has now been or is being addressed by accounting standard-setters in the context of conventional financial statements. However, the report also comments adversely and more fundamentally on the process of consulting users in setting business reporting requirements. ‘There has long been a contrast between the known importance of users’ needs and the relative absence in the standard-setting process of either reliable data about those needs or sufficient input from users.’ Overall, the report concludes that ‘Business reporting is falling short of providing all of the useful information it should provide to meet users’ needs for information.’

The recommendations of the Jenkins Report are designed to address the problem of insufficient focus on user needs.

4.2.2 *The solution*

The Jenkins Report recommends that a comprehensive model of business reporting should be developed. This would ‘indicat[e] the types and timing of information that users need to value and assess the risk of their investments.’ The committee developed its own model as a start. It states that ‘The model does not satisfy all of the users’ needs

for information... Rather, it provides that portion of information that is within management's expertise and for which management is the best source and which can be provided at acceptable costs'.

The report recommends that 'to meet users' changing needs, business reporting must:

- (a) Provide more information with a forward-looking perspective, including management's plans, opportunities, risks, and measurement uncertainties.
- (b) Focus more on the factors that create longer-term value, including non-financial measures indicating how key business processes are performing.
- (c) Better align information reported externally with the information reported to senior management to manage the business.'

It also states that 'management should disclose the measurements it uses in managing the business that quantify the effects of key activities and events.' The committee comments that 'non-financial information is important to understanding a company, its financial statements, the linkage between events and the financial impact on the company of those events, and predicting the company's future.'

The model includes a list of 10 'major components' of business reporting of which the financial statements are but one. The components are:

Financial and non-financial data

- Financial statements and related disclosures
- High level operating data and performance measurements that management uses to manage the business

Management's analysis of financial and non-financial data

- Reasons for changes in the financial, operating, and performance-related data, and the identity and past effect of key trends

Forward-looking information

- Opportunities and risks, including those resulting from key trends
- Management's plans, including critical success factors
- Comparison of actual business performance to previously disclosed opportunities, risks, and management's plans

Information about management and shareholders

- Directors, management, compensation, major shareholders, and transactions and relationships among related parties

Background about the company

- Broad objectives and strategies
- Scope and description of business and properties
- Impact of industry structure on the company

The report gives detailed lists of possible disclosures. These include, for example:

- 'Description and duration of important patents, trademarks, licenses, franchises, and concessions that offer the business a competitive advantage...'
- 'Description of major contractual relationships between the business and its customers and suppliers.'

The model also requires that companies ‘report separately on each business segment of [a] business having diverse opportunities and risks’; the committee notes that ‘because of its predictive value, improving segment reporting is of the highest priority.’

To address the issue of the credibility of new forms of business reporting, the report looks at the role of the auditor and the committee surveyed users’ views on the subject. The report’s key recommendation on assurance is to ‘allow for flexible auditor association with business reporting, whereby the elements of information on which auditors report and the level of auditor involvement with those elements are decided by agreement between a company and the users of its business reporting.’ It recommends a lower level of assurance when reporting on subjective information.

4.2.3 The desired result

The focus of the Jenkins Report is on the allocation of capital by investors. If investors do not have all the information they need to price securities correctly (or to make decisions on loans), then capital will be misallocated. If the recommended model is adopted, investors will have improved information, leading to an improved allocation of capital. ‘People in every walk of life are affected by business reporting, the cornerstone on which our process of capital allocation is built. An effective allocation process is critical to a healthy economy that promotes productivity, encourages innovation, and provides an efficient and liquid market for buying and selling securities and obtaining and granting credit.’

4.2.4 Responsibilities

The Jenkins Report allocates responsibilities to all the ‘participants in the business reporting process’. It states that they ‘must do a better job of anticipating change by:

- (a) Focusing on users’ information needs and finding cost-effective ways of better aligning reporting with those needs.
- (b) Developing and maintaining a comprehensive model of business reporting reflecting the kinds of information that users need...
- (c) Adopting a longer term focus by developing a vision of the future business environment and users’ future needs for information.’

Responsibility for these matters lies particularly with regulators (the SEC) and standard-setters (FASB). Other responsibilities identified for these groups are:

- ‘Regulators should consider whether there are any alternatives to the current requirement that public companies make all disclosures publicly available...’
- ‘National and international standard setters and regulators should increase their focus on the information needs of users’.

The report appears to envisage a mandatory disclosure regime in due course (with considerable built-in management discretion) preceded by a period of voluntary disclosures. As the main disclosures recommended by the report are, therefore, either voluntary in the short term or would in due course require decisions by managers as to what is appropriate to disclose in the case of their own business, the central responsibility falls on managers to decide what to report. ‘Standard setters, regulators, and users should encourage companies to experiment voluntarily with improved reporting based on the Committee’s model... High-level operating data and performance measurements will vary by industry and company. Management should identify those measures that it believes are significant and meaningful to its business, and that are leading indicators of the company’s future.’

The report recommends that ‘Those responsible for standard-setting processes should seek formal commitments to increase user participation from institutions representing users... . They should also consider novel means to get qualified users to focus exclusively on users’ needs ... (for example, focus groups...) ... standard setters should more aggressively search for, sponsor, and undertake research about how users make decisions and about the relative usefulness of various types of information in their decision-making process.’

FASB is also the recipient of a number of specific recommendations as to what it should *not* be giving priority to. ‘Standard setters should defer considering issues that have low priority according to the current evidence of users’ needs. The Committee’s study identified the following five areas that standard setters should not devote attention to at this time:

- Value-based accounting model
- Accounting for intangible assets, including goodwill
- Forecasted financial statements
- Accounting for business combinations
- Alternative accounting principles.’

The report explains that ‘users do not favour replacing the current accounting model’, that ‘despite the importance of internally generated intangibles, users generally oppose recognizing those assets in financial statements’ and that ‘although users are generally interested in forecasted financial and operating data, they generally believe that management should not include those forecasts in business reporting.’ A common theme in these negative user views is that users’ interest is in predicting future earnings and cash flows. The information they reject either would not, in their view, assist them in making such forecasts or would be a less successful attempt to do what they are doing anyway.

Legislators and regulators have a responsibility to secure safe-harbour protection for managers to allow them to make forward-looking disclosures.

It is not clear who should be responsible for allowing flexible auditor association with additional business reporting, but the report points out a number of difficulties with the kinds of additional reporting by auditors for which it finds user demand, and recommends research on the subject by the AICPA.

4.2.5 Motivation

The Jenkins Report itself was the work of the US accountancy profession, and reflected the profession’s concern at the relevance and reputation of business reporting. But however strong the profession’s motivation, it is not in a position itself to secure adoption of a new reporting model.

The Jenkins Report’s recommendations are designed to meet users’ needs, and its implicit message is perhaps that it is the *duty* of all the relevant parties to meet those needs. However, the process of meeting users’ needs is not one from which other parties can themselves expect any obvious direct gains.

Judging from the report, although users have strong views on various matters, one should not look to them to apply pressure to ensure that the committee’s model is adopted. If anything, it appears to require considerable effort to elicit users’ views on reporting issues and few responsibilities are placed on users to volunteer views which, on the face of it, they should feel motivated to provide.

4.2.6 Practical difficulties

By and large, if a particular disclosure would cause a problem, the Jenkins Report's model includes an exemption that either covers it or could be argued by management to cover it. So where the competitive costs or litigation costs of providing information are potentially significant, it is not required. Also, 'other than for financial statements, management need only report the information it knows. That is, management should be under no obligation to gather information it does not have, or need, to manage the business.' The model also states that 'management should not be required to provide forecasted financial statements. Rather, management should provide information that helps users forecast for themselves the company's financial future... Companies should not have to expand reporting of forward-looking information until there are more effective deterrents to unwarranted litigation that discourages companies from doing so.'

The report also recognises the potential problem of the credibility of new reporting and points out that auditor association with the recommended disclosures is an option. However, presumably auditor reluctance to provide assurance reports would be another factor limiting the scope of the report's impact on companies' actual reporting practices.

4.2.7 Monitoring progress

The AICPA and FASB invited comments on the Jenkins Report and it has resulted in a number of follow-up activities, including FASB's Business Reporting Research Project. This project produced several publications, including *Electronic Distribution of Business Reporting Information* (2000) and *Improving Business Reporting: Insights into Enhancing Voluntary Disclosures* (2001). *Business and Financial Reporting: Challenges from the New Economy* (2001) is an associated FASB special report.

Improving Business Reporting looks at voluntary disclosures by 62 US listed companies spread across eight business sectors; the 'voluntary' disclosures examined include those made to comply with mandatory management discussion and analysis requirements. The report provides a mass of examples of voluntary disclosures (by describing the subject of the disclosure rather than by quoting from the actual company reports). It also gives some overall conclusions on particular categories of disclosure. These include:

- General – 'Companies in the pharmaceutical industry [see below] made considerable disclosures about their research and development activities and product development pipeline. Disclosures by companies in other industries were generally sparse. The few disclosures found tended to be somewhat vague and not particularly helpful.'
- Automobile industry – 'Companies disclosed brand logos and lists of brands, but there was virtually no attempt to discuss strategies for the development of brands and little discussion of intangible and knowledge assets.'
- Chemical industry – 'There has been a significant increase in the quality of voluntary disclosures by companies in this industry over the last five years. This has resulted from competition – competition for capital. After one company provides a particular disclosure requested by investors, other companies tend to follow suit.'
- Food industry – 'Disclosures of forward-looking information and intangible assets were infrequent and general in nature.'
- Pharmaceutical industry – 'A significant number of voluntary disclosures were made by each company concerning its individual products. The information disclosed was in sufficient detail to explain product history, expected lifespan, and future uses for each product or product group.'
- Textile-apparel industry – 'Relatively few notable disclosures were found.'

The FASB report shows that there is a good deal of forward-looking and non-financial disclosure by companies but that this disclosure is uneven both in quality and in coverage.

The Jenkins Report has also provided a framework for empirical research on corporate disclosure in the UK. Valuable evidence comes from *Through the Eyes of Management: A Study of Narrative Disclosures* by Vivien Beattie, Bill McInnes and Stella Fearnley, published in 2002 by the ICAEW. The report analyses narrative disclosures in the 1999 reports of 11 UK listed food-processing companies and explicitly sets out to see how narrative reporting practices ‘match up against the Jenkins model.’ The report includes numerous examples of disclosures.

The researchers note that disclosures regarding strategy and objectives tend to be at the group level, even though, as the Jenkins Report indicates, investors want the disclosures at the segment level. They also note the findings of a ‘study of strategy disclosure in Dutch annual reports (the only other study into strategy disclosure of which we are aware).’ This survey, based on a study of 73 companies, concluded that ‘especially little attention is paid to objectives, monitoring, business unit goals and future-oriented action plans’. The British authors comment that, ‘based on our findings, the same could be said for the UK.’ They also note that only a minority of the companies in their survey make environmental or community disclosures.

The researchers observe that ‘very low amounts of information were disclosed about ... employee satisfaction, customer satisfaction, and innovation. This suggests that accounting narratives are not being widely used to provide information about key intangible assets.’ This is surprising because, as the authors point out, the food-processing sector is one ‘where brands are likely to play a significant role.’

The key conclusions to be drawn are that at the date of the material surveyed:

- there was already a good deal of narrative disclosure of the kind demanded by reformers; but
- its quality was uneven, and on some important topics little or nothing was disclosed.

While progress on non-financial disclosures in the UK has been real, therefore, it has also been patchy.

4.3 Tomorrow's Company

Tomorrow's Company puts forward an inclusive approach to business and business reporting, in which there would be a broader focus on stakeholder relationships and less emphasis on financial measures.

Tomorrow's Company: The Role of Business in a Changing World was an inquiry set up by the London-based RSA (the Royal Society for the Encouragement of Arts, Manufactures & Commerce). It reported its findings in 1995. The focus of the inquiry was British companies' ability to compete internationally, rather than business reporting, but it made some recommendations on reporting. The inquiry led to the setting up of the Centre for Tomorrow's Company, now known simply as Tomorrow's Company, which has produced a number of publications and which set out its ideas for companies' annual reports in *Sooner, Sharper, Simpler: A Lean Vision of an Inclusive Annual Report* (1998).

4.3.1 The problem

Tomorrow's Company argues that British companies are damaged by, among other things, not only a 'national adversarial culture' but also their 'over-reliance on financial measures of performance'. The report's criticisms of financial reporting are hard-hitting. 'By itself, financial performance does not gauge the overall health of the business. It neither defines competitive performance, nor measures the broader value created through product quality, speed of response and service.'

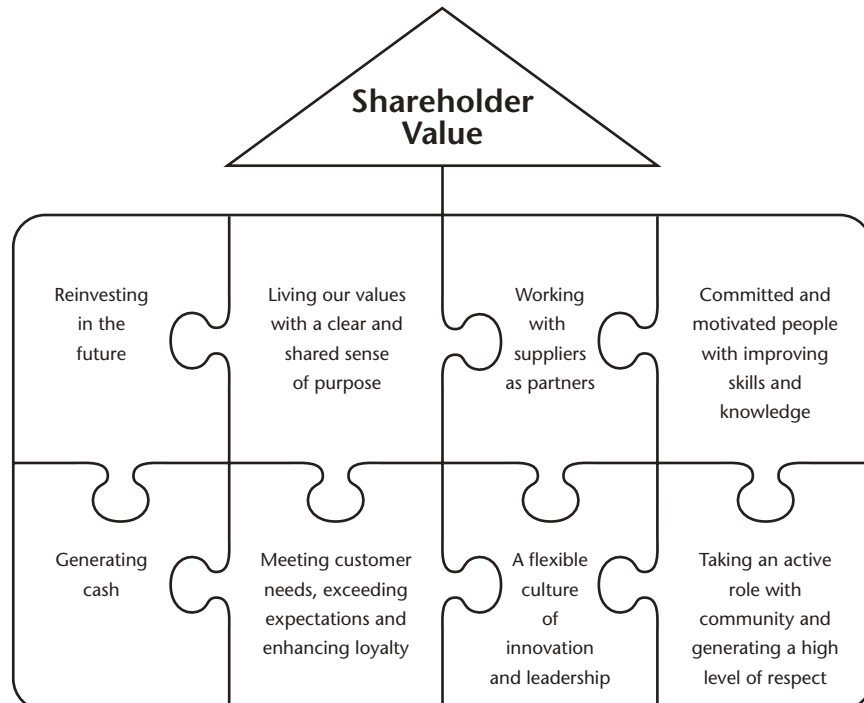
The report also argues that although 'good financial performance is the UK's traditional definition of success for a business... Historic financial measures are lagging indicators: they are an unsatisfactory guide to future performance.' The report notes the growing importance of intangibles: 'The centre of gravity in business success is ... shifting from the exploitation of a company's physical assets to the realisation of the creativity and learning potential of all the people with whom it has contact – not just its employees.'

4.3.2 The solution

In order to succeed, companies need to 'focus less exclusively on shareholders and on financial measures of success'. Instead, they should 'include all their stakeholder relationships, and a broader range of measurements, in the way they think and talk about their purpose and performance.' The report calls this an 'inclusive' approach. 'UK companies need to go beyond the limitations of traditional accountancy. They need new criteria, new measures and a new language of success.'

The inclusive approach is summarised in Figure 2:

Figure 2: Tomorrow's Company



*This diagram has been copied from the report **Sooner, Sharper, Simpler: A Lean Vision of an Inclusive Annual Report** published by Tomorrow's Company. For the full copy of the report please contact Tomorrow's Company on www.tomorrowcompany.com. Reproduction of this diagram is not permitted without the consent of Tomorrow's Company.*

Once it has developed an inclusive success model, a company should identify success measures that match the model. For example, if a company's model is expressed in terms of customers, employees and cash, key measures might be customer loyalty, employee

morale and cash flow. Success measures should also include ‘*measures of the strategic health of the business* – for example, the rate of introduction of new products, the extent to which stated values are shared by all employees, or progress towards agreed learning targets’.

The report is primarily addressing internal rather than external reporting in these recommendations. But it also specifies that a company should ‘produce annual reports containing clear statements about its purpose and values, its definitions of success, and its key relationships – with customers, suppliers, providers of capital, employees and the community – as well as relevant disclosure of its progress.’ The report cites environmental reporting by companies as an example of inclusive reporting.

In summary, the report does not propose changes to financial reporting, but that it should have a less important role in an extended reporting model, which would include reports on non-financial performance, especially on such matters as the environment and relationships with employees, customers, suppliers and the community.

Tomorrow’s Company, in *Sooner, Sharper, Simpler*, subsequently proposed a short annual report to appear at the same time as its preliminary results announcement, with further information in appendices and supplementary reports. All these reports would appear on the company’s website as well as in printed form. The short core document ‘would communicate sharply and simply the company’s past, present and future.’ The annual report should describe ‘how the company has generated and will continue to generate value for its shareholders, while at the same time identifying and measuring the part played by customers, employees, suppliers and the community in creating and sustaining that value.’ This reflects the inclusive approach, which is the basis of the Centre’s work.

The supplementary reports would be a ‘financial report’ (which would include the profit and loss account, balance sheet, etc), a ‘value chain report’ (including information on customer satisfaction, etc), a ‘people document’ (including information on skill levels and knowledge bank, etc) and a ‘sustainability document’ (including community and environmental impacts, etc).

4.3.3 The desired result

By behaving and reporting in an inclusive manner, companies will perform better against international competitors, and shareholders will enjoy higher long-term rewards: ‘only by giving due weight to the interests of all key stakeholders can shareholders’ continuing value be assured.’

Complying companies will also enjoy improved relations with their investors. ‘Tomorrow’s Company and its investors are able to free themselves from the trap of an adversarial relationship, and together create a climate of increased trust and deeper understanding. The company is consistent in its disclosure policy and reports both positive and negative trends.’ But it is inclusive conduct, rather than just the reporting of it, that provides the key to success.

4.3.4 Responsibilities

The responsibility for implementation falls primarily on business leaders comprising directors and managers who ‘must ... take action to create a new language of business success, to develop effective new measurement systems, and to bring the reporting process into line.’

However, a wide-ranging list of other relevant sections of the community is also identified. These include analysts, fund managers, pension fund trustees, actuaries, auditors, learners, parents, schools, career advisers and management educators as well as the government. It needs to be borne in mind that what is being implemented is the inclusive approach to business, rather than merely a new reporting model.

Tomorrow's Company has a detailed action plan. 'The Inquiry has set out [a convincing framework for turning intention into action], by describing how *Tomorrow's Company* can apply an *inclusive* approach as a route to sustainable success, supported by investors, educators and policy makers... However, the *specific actions* needed to apply this framework throughout the UK business environment can be identified – and implemented – only by the people involved. To help launch this process, the Inquiry has developed agendas for action.' There are four agendas covering (1) directors, (2) managers, (3) the investment community and (4) learners and educators.

The directors agenda has 10 points, including: '**Measurement** – Do we review the company measurement system annually, against its ability to support our goals, purpose, values and key relationships? Do we measure outcomes as well as outputs? Is sufficient time spent reviewing relationships? Do we receive a regular report on issues such as reputation, *licence to operate* and environmental impact?'

The managers agenda has nine points, including: '**Measurement** – Do we have a useful overall measure of management effectiveness? Do our measures match our success model? Are they applicable to the context of our business? Do we measure progress in each relationship? Are we fully reflecting the level of public interest in our business in terms of measuring our *licence to operate*?'

4.3.5 Motivation

Although there is a presumption that implementing the recommendations will be in the public and national interest, it is recognised that people need more immediate incentives. The motivation for directors and managers is that by behaving inclusively their company will perform better financially and against international competitors, though – since fighting short-termism is one of the report's objectives – not necessarily in the short term.

However, it is noted that there is unlikely to be any pressure from shareholders to implement the RSA report's recommendations. It notes that 'in a... survey of investors, treatment of customers, treatment of employees and environmental performance were all assigned low importance as criteria in making judgements about companies'. Consistent with this, it also records that 'Investors are perceived [by companies] as placing a relatively low priority on the business fundamentals – such as customer loyalty, investment in people and supplier relationships'. There is a gap, therefore, between what investors see as the sources of success and the report's recommendations.

4.3.6 Practical difficulties

The RSA report does not deal with any practical difficulties that may be encountered in implementing its proposals.

4.3.7 Monitoring progress

We do not know of any work that has been done to monitor the adoption by companies of *Tomorrow's Company's* particular vision of an inclusive approach to business and reporting by British business, but its ideas were influential in the recent UK Company Law Review, and particularly in the CLR's proposals for a mandatory operating and financial review.

4.4 The 21st Century Annual Report

The 21st Century Annual Report proposes that businesses publish a wider range of leading indicators of financial performance, take a more inclusive view of stakeholders, and harness advances in information technology in their reporting.

The 21st Century Annual Report, published by the Institute of Chartered Accountants in England & Wales in 1998, mainly comprises the proceedings of an Institute conference edited by Anthony Carey and Juliana Sancto. It is supplemented by a set of accounts *Prototype plc* available in hard copy and on CD. This, inspired by Alan Benjamin and prepared in conjunction with the Centre for Tomorrow's Company, shows what a 21st century annual report might look like and how it is possible to drill down from higher levels of information to more detailed data below.

Performance Measurement in the Digital Age: Adding Value to Corporate Reporting ('Performance Measurement'), also published by the ICAEW in 1998 (and also edited by Anthony Carey and Juliana Sancto) is another conference report. It preceded *The 21st Century Annual Report*, and touches on many of the same issues, though less comprehensively.

Both these publications were the work of the ICAEW's Centre for Business Performance. Other publications produced by the Centre that are relevant to the issues discussed in this report include: *New Measures for the New Economy* (2000) by Charles Leadbeater, *Market Metrics: What Should We Tell the Shareholders?* (2001) by Tim Ambler, Patrick Barwise and Chris Higson, and *Valuing Intangibles* (2001) by Caroline Vance.

4.4.1 The problem

In *The 21st Century Annual Report*, Chris Swinson of BDO Stoy Hayward, then president of the Institute, notes the 'unhappiness with the usefulness of historical cost financial reports', which 'do not attempt to meet the information needs of all users of accounts'. He argues that 'the assets and risks not measured by historical cost accounts appear to be becoming more important as determinants of a business's future success. Neither human capital nor intellectual capital is valued in historical cost accounts and many businesses' accounts give almost no indication at all of the nature and possible extent of their environmental obligations.' He also points out that 'there are inequities in the way in which information is provided – privileged analysts rely on direct briefing from companies themselves.' He concludes that: 'We ought to ask how we can encourage financial reporting to meet the changing information needs of business and society.'

In *Performance Measurement*, Sir Brian Jenkins, chairman of the conference and a past-president of the Institute, identifies the following four factors as among the principal ones challenging the present accounting system:

- 'the exponential growth in financial instruments and other derivatives, which it is impossible to reflect properly using historical cost accounting'
- 'the greatly increased importance of intangible assets in the generation of corporate wealth and the very tenuous link between the cost and value of these assets'
- 'advances in information technology, making possible radical changes not just in how we communicate information but also in what information is published, to whom and when'
- 'the strong influence of international institutional investors, e.g. from the USA, pressing for more transparency in corporate reporting.'

4.4.2 The solution

As well as acknowledging the need to report a wider range of leading indicators of financial performance and the importance of a more inclusive view of stakeholders, *The 21st Century Annual Report* advocates the use of IT and web-based technology to allow users to tailor information to their needs and to make access to information faster and fairer.

The editors provide a summary of the differences between the 'old' system of reporting and the 'new'.

Table 2: The 21st Century Annual Report

<i>The 'old' system</i>	<i>The 'new' system</i>
Shareholder focus	Stakeholder focus
Paper based	Web based
Standardised information	Customised information
Company controlled information on performance and prospects	Information available from a variety of sources
Periodic reporting	Continuous reporting
Distribution of information	Dialogue
Financial statements	Broader range of performance measures
Past performance	Greater emphasis on future prospects
Historical cost	Substantial value-based information
Audit of accounts	Assurance of underlying system
Nationally orientated	Globally based
Essentially static system	Continuously changing model
Preparer-led regulations	Satisfying market-place demands

Sir Brian Jenkins emphasises changes in IT. 'With technology, a whole new vista of opportunities is... opening up and we are in the world of á la carte with potentially infinite alternative menus of information able to be given to users of financial data... Whilst technology is an enabler, if its potential is to be realised, many businesses will need to change their approach to providing information, moving away from primarily seeking statutory compliance and towards meeting market needs. And there is a variety of different markets including, for instance, financially sophisticated investors who may have large or small holdings, those more interested in non-financial performance information and users primarily interested in social accountability issues... In this new world, the notions of what information should be included on performance measures will also be subject to substantial change with more sought on non-financial performance indicators and on, for example, the value of a company's intangible assets, including its human resources and satisfaction ratings, the key drivers of wealth in many companies.'

Chris Fay, then chairman and chief executive of Shell UK, argues in favour of social and environmental reporting. 'We are clearly,' he says, 'at the start of a long and difficult journey towards a new type of business reporting which takes account of economic, environmental and social performance... The days when companies were judged solely in terms of economic performance and wealth creation have long disappeared... [T]he successful company of the future will need to demonstrate, year on year, progress towards greater openness ... and, above all, tangible progress towards external verification of financial, environmental and social performance.'

Alan Benjamin, then chairman of QSP Holdings, predicts that ‘the annual report of the 21st century will not be annual and it will not be a report: it will be an up to date, informative, permanent dialogue.’

In *Performance Measurement*, Graham Ward of PricewaterhouseCoopers (and a subsequent president of the Institute) calls for more disclosure of forward-looking financial information and better information about risk, including environmental risks. Paul Myners, then chairman of Gartmore Investment Management, predicts real-time reporting by companies on the internet and open dialogue, also on the internet, with individual shareholders.

4.4.3 The desired result

This is not discussed at length in either report, but the main benefit identified – by more than one speaker – is a lower cost of capital.

4.4.4 Responsibilities

As the proposed changes in both reports are voluntary, the responsibility for implementing them falls on management.

4.4.5 Motivation

Managers should be motivated by the prospect of a lower cost of capital.

4.4.6 Practical difficulties

In *The 21st Century Annual Report* Sir Brian Jenkins concedes that ‘there will undoubtedly be challenges to be faced in the new era such as deciding how to strike the balance between transparency and not giving away too much competitively sensitive information as well as determining how frequently information should be updated.’

As well as referring to the conflict between commercial confidentiality and openness on performance targets, Chris Fay notes problems in achieving environmental benchmarking across industries (‘an enormous task which may in the end prove fruitless’) and the possible impossibility of developing objective indicators for measuring a company’s social performance. However, he challenges ‘the rather blinkered view that concern for the environment or community involvement in some way damages companies’ underlying financial performance.’

Another problem that Fay identifies is ‘the question of resources ... auditing and verification demand significant resources, skills, management time and capabilities which may simply be lacking in smaller organisations.’

In *Performance Measurement*, Graham Ward identifies the constraints imposed by commercial sensitivities and the threat of litigation arising from forward-looking information (against which he calls for safe-harbour protection).

4.4.7 Monitoring progress

Progress on the adoption of the changes envisaged in *The 21st Century Annual Report* has not been monitored.

4.5 The Inevitable Change

The Inevitable Change argues that, to meet users’ needs, businesses should use advances in information technology to make available a wider range of information faster than at present, rather more frequently, and recognising different stakeholders’ differing requirements.

Business Reporting: The Inevitable Change?, edited by Vivien Beattie, was published by the Institute of Chartered Accountants of Scotland in 1999. It is based principally on surveys of users' views, though the views of preparers and auditors were also surveyed.

4.5.1 The problem

'Traditional financial reporting, developed for manufacturing companies with mostly 'hard' assets, and rooted in the periodic reporting of aggregated, historical, financial information, no longer satisfies users. Because large volumes of data can now be filtered effectively, users are demanding more data.' Business reporting at the moment is producer driven, rather than meeting users' needs.

4.5.2 The solution

The report sets out 'a blueprint for business reporting'. This recommends that:

- 'an electronic library-type resource, based on the corporate database, be made available to external users...'
- 'existing technology be exploited to layer and link information, to provide direct links to non-company databases; and to maintain a facility for free search...'
- 'a range of pre-packaged information be provided, based on a standardised template for each stakeholder group...'
- 'access to general company meetings be extended via live broadcast, with records being placed in the library'
- 'access to one-to-one meetings [with investors] be extended via minutes being placed in the library...'
- 'a facility for on-line questioning of management via the electronic library be made available...'
- 'access to a wider range of information be available, where there is a clear external demand. In particular:
 - at three to five yearly intervals, selected prospectus type information be provided;
 - certain non-financial information currently captured by management information systems be provided e.g. performance indicators; and
 - certain information not currently captured by management information systems be provided e.g. intellectual capital, biographical information on directors...
- 'regular, periodic reporting be retained; and ...a moderate increase in frequency be effected as users adapt to changing practice...'
- 'there is a shift towards the assurance of processes in addition to outputs; and ... multiple levels and forms of assurance be developed.'

The report envisages three phases in the blueprint's implementation: 'a series of short term measures combined with positive encouragement of experimentation by preparers, to be followed by incorporation of best practice into voluntary codes, and finally, in the long term, the possibility of mandatory regulation.'

4.5.3 The desired result

The proposals are intended ‘to reduce the business reporting expectations gap without serious cost to preparers and assurance providers. This, in turn, will reduce current iniquities, improve the allocation of capital in the economy and reduce companies’ cost of capital.’

4.5.4 Responsibilities

The changes proposed in *Business Reporting: The Inevitable Change?* are voluntary, and the ultimate responsibility for implementing them therefore lies with managers. However, the report also proposes that ‘the profession actively encourages and assists in bringing about change incrementally. This can be achieved by fostering discussion and debate among interested parties, by undertaking empirical and theoretical research into, for example, the measurement of non-financial indicators and into the nature of related assurance services, and by encouraging companies to experiment with the form and content of their business reporting package.’

4.5.5 Motivation

Managers should be motivated to implement the proposals by the prospect of a lower cost of capital.

4.5.6 Practical difficulties

The report’s voluntary and incremental approach is intended to avoid potential difficulties.

4.5.7 Monitoring progress

There does not appear to have been any monitoring of implementation of the recommendations in *Business Reporting: The Inevitable Change?*, although ICAS has subsequently published further research on users’ views on (a) the use of the internet to disclose information and (b) the disclosure of non-financial information.

4.6 Inside Out

Inside Out proposes that listed companies should disclose more about their strategies and value drivers, including the measures and lead indicators used at board level to manage the business.

Over the past few years, the ICAEW has issued a series of longer studies on particular aspects of the reform of corporate reporting. For the purposes of this report, *Inside Out: Reporting on Shareholder Value* (1999) is the most relevant because it prescribes a potentially comprehensive model of reporting. Other relevant ICAEW publications include *No Surprises: The Case for Better Risk Reporting* (1999) and *Prospective Financial Information: Guidance for UK Directors* (2003).

4.6.1 The problem

‘Many managers believe that a gap exists between the internal perception of a company’s potential and that of the stock market’, and the report explains why the gap may exist. ‘Investors today want information about a company’s potential for creating shareholder value. Value is created by enhancing a company’s prospects and this, to a large degree, stems from a company’s competitive advantage together with the ability of management to choose and implement a strategy which exploits that advantage... Annual reports give a primarily historical perspective and provide limited information on these matters... the reporting of forward-looking information by companies is generally very sparse... The future is uncertain and cannot be reported as a matter of fact, but reporting the past alone is no longer enough.’

Inside Out: Reporting on Shareholder Value identifies key information that investors want, but don't get from published reports. 'When given the opportunity to question management, it is our experience that analysts and institutional investors are keen to understand a company's strategy and the key 'drivers of value' that must be managed in order to execute that strategy. Questions asked include:

- What is the company's strategic vision and strategy for achieving it?
- Why is that the appropriate direction?
- Does the organisation have the capability to implement the chosen strategy?
- What does management need to manage in order to achieve its objectives?

These are important issues that should be addressed in the annual report. We believe it to be undesirable for the answers to be restricted to those able to attend a briefing meeting.'

The report states that 'the OFR has not developed into 'an essentially forward looking' operating and financial report... Surveys of OFR reporting consistently show that companies have been slow to respond to the needs of investors and the challenge of providing forward looking information, both financial and non-financial... In addition, the emphasis on historical, financial effects is unfortunate because accounting profit is an unreliable indicator of the creation of economic value, especially where significant expenditure that is expected to confer a future benefit is charged against profit in the financial statements. Such 'revenue investment' includes spending on brands, research and development, people, knowledge management and innovation... The annual report must include more information useful to investors' decision-making or it will become, at best, a secondary source of information.'

4.6.2 The solution

The principal recommendation is that there should be greater alignment between companies' internal and external reporting. The report proposes a range of mainly qualitative disclosures by listed companies, designed to provide investors with 'information about a company's potential for creating shareholder value' and to introduce 'a more forward looking perspective into annual reports'. The proposed disclosures reflect users' observed interest in learning more about companies' strategies and key value-drivers. 'We believe that the annual report should be designed with the aim of encouraging managers to report both why their strategies are expected to lead to the creation of value over the long term and their view of performance.'

The Inside Out approach is that 'the measures and the lead indicators used, at board level, to manage a business are equally important to the stock market in ensuring a fair judgement of the business and reliable forecasts of future returns... Management must be more open in the external disclosure of key elements of the information used internally to manage the business.'

The report summarises its recommendations for key disclosures to sit alongside the financial statements as follows:

'For the company as a whole:

- Its ambitions;
- Its strategic direction, together with targets or milestones towards achieving its objectives;

- A description of the strategic decision-making process;
- The preferred measures used internally to monitor economic performance.

'In addition to the above, for each significant business activity as identified for management purposes:

- A description of the key drivers of value in the business, derived from, inter alia:
 - A description of the market in which the business operates, using both qualitative terms and quantitative data;
 - Why management believes it is the right market to be in;
 - The business's competitive position within the market;
 - Future trends anticipated in the market;
 - How management intends to maintain or alter the business's position within the market.
- Measures of performance appropriate to the business, including non-financial measures, and/or lead indicators, derived from the key drivers of value, that are used internally to monitor potential in that business.'

The report asks companies 'to experiment immediately with the additional disclosures we propose'. It also recommends that 'factual disclosures made in analyst and investor briefing meetings should be incorporated into the annual report.'

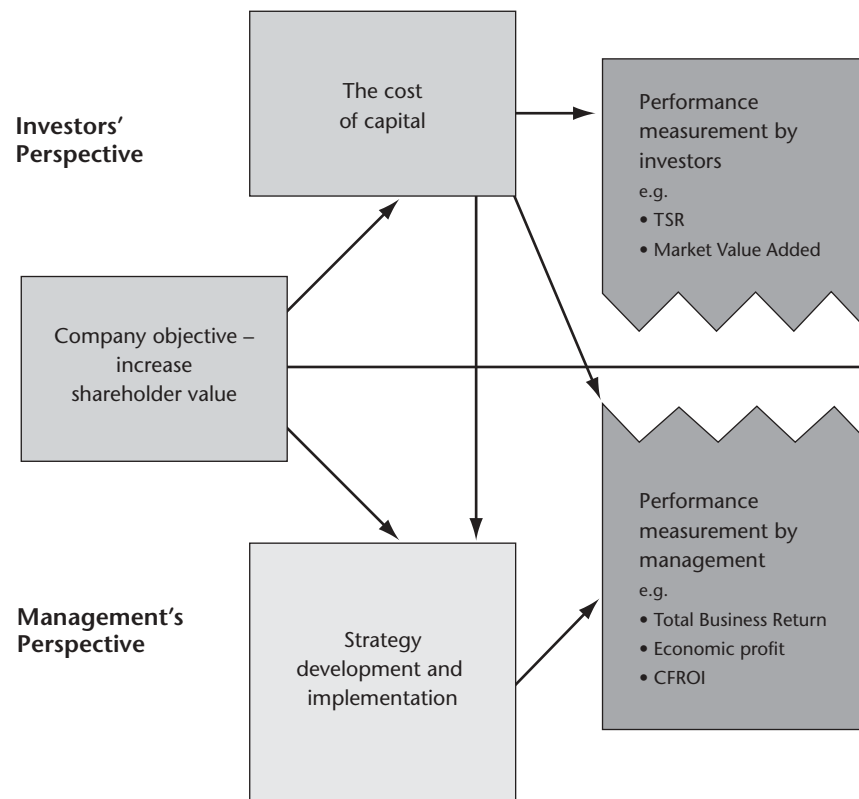
4.6.3 The desired result

Inside Out disclosures are intended to bridge the gap between managers' perceptions of their companies' potential and the market's. Also, by allowing investors to value companies more accurately, the proposed disclosures 'may reduce capital market volatility'.

The recommended disclosures 'will enable investors to make their own assessments of the future prospects of a business and take better-informed decisions... An improved understanding of the business and management's objectives will permit investors to assess performance against the targets set by management and should, therefore, build management credibility. Better information about the risks and opportunities faced by the company should help investors to value a company more accurately and with less uncertainty, which may reduce capital market volatility.'

Figure 3 'summarises key elements of the internal and external perspectives on shareholder value creation. While management and investors both measure value created, it is management that creates value by developing and implementing an appropriate strategy that recognises the cost of capital.'

Figure 3: Inside Out



4.6.4 Responsibilities

The responsibility for implementing the ideas of Inside Out falls on management.

4.6.5 Motivation

The motivation for managers is that the proposed disclosures will secure a more realistic and less volatile share price for their company. 'The market will reward those companies able to demonstrate that they have a clear strategic vision and the capability to implement it effectively.'

4.6.6 Practical difficulties

Inside Out, like the Jenkins Report, avoids some of the major obstacles by fitting its recommendations around them. It proposes 'the disclosure only of information already available to management.' It also addresses the issue of commercial sensitivity: 'we are aware that there will be some information that management believes to be too commercially sensitive to disclose either because it would damage a business's competitive advantage or because it could prejudice the outcome of a future event. It is for management to decide upon the extent of additional disclosures. However, in exercising their judgement, we ask that they do not consider only the potential costs of disclosure but weigh against that the benefits that increased transparency can offer, either directly through an improved relationship with investors, or indirectly as a result of competitors' disclosures.'

4.6.7 Monitoring progress

Inside Out: Reporting on Shareholder Value includes a chapter giving examples of reporting disclosures along the lines it recommends. However, there has been no subsequent monitoring of progress in the disclosure of non-financial information of the type recommended in the report.

4.7 Value Dynamics

Value Dynamics argues that companies should be more transparent and user-driven in their disclosures; in particular, they should disclose the current values of all their assets, including intangibles not currently recognised in financial reporting.

Cracking the Value Code: How Successful Businesses are Creating Wealth in the New Economy ('*Cracking the Value Code*') by Richard E. S. Boulton, Barry D. Libert and Steve D. Samek of Arthur Andersen was published in the United States in 2000. As its title suggests, it is primarily about businesses creating wealth, but it pays significant attention to reporting issues. Its central concept is 'Value Dynamics'.

4.7.1 The problem

Cracking the Value Code, using research that shows a long-term decline in the ratio of book value to market value of US quoted companies, points out the inadequacies of traditional accounting. 'Organizations are creating value in totally new ways, using assets and combinations of assets heretofore unrecognized under traditional accounting systems – and certainly unmeasured... Old methods of managing and measuring are simply not up to the task... In the New Economy, it is intangible assets such as relationships, knowledge, people, brands, and systems that are taking center stage... Leading-edge companies are finding that their management and measurement systems are no longer aligned with the assets that they are using to create value... Businesses must recognize that the old models of information for decision-making – including measurement and reporting – are becoming obsolete.'

It is predicted that 'in the not-so-distant future', it will become clear that 'what is most enduring is also what is most intangible – relationships and knowledge. At the same time, what was once regarded and measured as an asset (for example, things) is now regarded as an expense. In other words, these are costs to be eschewed, areas to be cut – whenever and wherever possible... On the other hand, everything that was either defined as an expense or overlooked (people, customers, research and development, insight) is now an asset – something to be acquired and cherished.'

The authors 'draw a key distinction between value creation and value realization. Value creation – that is, future value captured in the form of increased market capitalization – is how successful businesses are creating value in the New Economy. Value realization – that is, value captured in the form of past and current earnings or cash flows – is what underlies both traditional accounting and most of today's management information systems...'

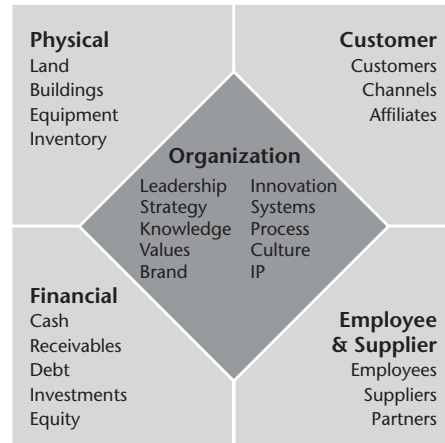
Cracking the Value Code also notes that 'users of financial information are ... diverse, as are their needs. And they are demanding more meaningful, detailed and disaggregated information, rather than one-size-fits-all reports'.

4.7.2 The solution

The authors state that companies have 'resist[ed] disclos[ing] more than the bare minimum required by legislation.' This will have to change. 'The model of the future is transparent and user-driven, and allows stakeholders to readily access the information

they need to know, when they need to know it. Companies will need to measure all of their value-creating assets, including the difficult to measure intangibles.’ This concern to measure and report all a company’s assets is driven by an asset-based approach to business and value creation that the authors refer to as Value Dynamics.

Figure 4: Value Dynamics Asset Framework



Value Dynamics involves analysing all issues of strategy, business model design, business processes and risk management in terms of five kinds of asset: physical, customer, organisation, financial, and employee and supplier. The authors point out that they ‘do not use the word asset in the manner prescribed by existing accounting rules. Value Dynamics defines assets as all potential sources of future economic benefit that have the capacity to contribute to a company’s overall value... Conventional accounting definitions of assets are based on concepts of control and exclusivity. Value Dynamics holds that assets encompass sources of value both within a company’s control and outside it. Sources of value ... may include ... customer and partner assets ... Customer assets provide information and money. Employee and supplier assets provide products and services, skills, and knowledge. Organization assets provide a range of outputs – from patented know-how to codified processes and systems.’ Financial assets include the ability to raise debt and the ability to raise equity.

The authors of *Cracking the Value Code* predict that ‘in the New Economy, companies will need to continuously measure and report all assets at fair value to all users.’ They also predict that as new web-based markets for all manner of assets develop ‘emerging technologies will ... allow ... companies to derive information daily or even hourly through information delivered to the corporate desktop.’

The authors also provide a Value Dynamics Information Framework, which sets an agenda for collecting information across the entire asset base of a company. This sets out a three-dimensional matrix for what needs to be captured by a business’s information system. The first dimension comprises the five categories of asset recognised by Value Dynamics together with the configuration of assets represented by the company’s business model. The second dimension categorises information on these assets as relating to one of the following: the external environment, the processes used to manage the business, and value. The third dimension is time: past, present, and future.

The matrix therefore contains 54 ‘boxes’ showing the different kinds of asset-related information that a business needs to collect and use if it is to manage what matters.

One box would, for example, would be information under the heading customer/environment/future, which would challenge businesses to find out about how their customer base was expected to be affected by demographic and economic trends; and so on.

The authors present a table summarising the changes from present to future reporting:

Table 3: Value Dynamics Measurement and Reporting

<i>Measurement/Reporting Framework</i>	<i>Current State</i>	<i>The Future</i>
<i>Reporting framework</i>	Financial statements (preparer and regulator-driven)	Corporate database – electronic library (preparers and users customize reports on an as-needed basis)
<i>Focus</i>	Value realized	Value created (and realized)
<i>What is measured?</i>	Physical and financial assets	All assets – tangible and intangible
<i>Source of information</i>	Internal data	Integrated internal and external data
<i>How measured/reported?</i>	Primarily at historic cost	Fair value. KPIs developed for difficult-to-measure intangible assets
<i>Where delivered?</i>	Hardcopy distribution and limited electronic distribution	Computer desktops and other devices – wherever it is needed
<i>When available?</i>	Periodic	Continuous
<i>In what format?</i>	Numbers/words	Numbers/words/graphic visualizations and interactive interfaces
<i>To whom reported?</i>	Certain stakeholders as required	All stakeholders eventually
<i>Additional information</i>	Limited	Risk management, strategy, etc

4.7.3 The desired result

The overall desired and anticipated result is greater value creation as businesses focus on managing and reporting what matters for value creation. ‘The premium for openness (or transparency) is going to rise dramatically in the coming years. Research shows that reporting more to investors and other stakeholders than is required under law can benefit an organization. We are already seeing investors, customers, employees and other partners flocking to those companies that are providing the best information for informed decision-making. Companies that gain a reputation for openness are likely to find a market more forgiving of occasional bad news. Investors will reward such openness by reducing the rate of return they require from a company, thereby lowering the company’s cost of capital.’

4.7.4 Responsibilities

The responsibility for implementing the book’s ideas falls mainly on management, but there is also a ‘Call to Action’, which distributes responsibility more widely:

- ‘Management must strive to obtain complete, real-time information about the fair value of all their assets so that they can set strategy, master risk, and measure and report on the entire value creation process.’
- ‘Boards of directors need information about all the assets that drive value so that they can properly discharge their duties of stewardship and governance.’
- ‘Investors should demand information transparency so that they direct resources where they will create the most value.’

- ‘Employees should actively participate in open, two-way communication with employers to enhance their ability to create value for themselves and others.’
- ‘Customers should seek out organizations that understand and address their needs so that they and their suppliers will prosper.’
- ‘Standard-setters and regulators should encourage the development of new measurement and reporting systems that enhance information transparency.’
- ‘And, finally, policy-makers should promote the measurement and reporting of all sources of value to all stakeholders so that they have a sound basis for developing monetary, fiscal and social policies.’

4.7.5 Motivation

Managers will be motivated to adopt the proposals by the prospect of a less volatile share price that reflects the company’s value creation and by the increased ability to attract investors, customers, employees and other partners.

Others who are called to action are presumed to be motivated by a similar desire to create value.

4.7.6 Practical difficulties

The authors concede that things will not happen instantly. ‘Needed changes in information management, measurement, and reporting cannot be achieved overnight, given the challenges of replacing legacy systems, complying with today’s regulatory requirements, and developing the tools required for hard-to-measure intangible assets.’

The authors recognise in particular that there may be difficulties in establishing fair values for some assets. ‘Where fair market values are not available or cannot be determined, we believe companies must look to innovative ways to measure the performance of their intangible assets.’

However, general adoption of the proposed changes is confidently predicted and the authors express optimism that ‘a combination of existing and emerging measures, including KPIs... will allow companies, including yours, to measure tangible and intangible assets at fair value.’

4.7.7 Monitoring progress

Progress on the adoption of the recommendations in *Cracking the Value Code* has not been monitored.

4.8 GRI

GRI provides an evolving template for businesses to report information measuring their economic, social and environmental performance.

Global Reporting Initiative™, or GRI, is ‘both an institution and a reporting framework’ and issued its first *Sustainability Reporting Guidelines* in 2000. A revised version of the guidelines was issued in 2002 and what follows refers to that edition.

4.8.1 The problem

The *Sustainability Reporting Guidelines* refer to financial reporting’s failure to recognise intangible assets. ‘Many observers – including accountants themselves – recognise that characterising the ‘bricks and mortar’ economy of the past will not suffice as a basis for characterising today’s information economy.’

However, GRI is not an attempt to solve the problems of accounting for intangibles, and the key issue for GRI is that financial reporting does not reflect new expectations of responsibility that are placed on business. In particular, it does not enable people to assess whether the activities of a business are compatible with economic, environmental and social sustainability: i.e. do those activities represent an overall contribution to, or drain on, the economic prosperity, environmental resources and social welfare of those stakeholders affected by the business? Financial reporting just covers a subset of the economic impacts of a business.

4.8.2 The solution

GRI advocates 'triple bottom line' reporting that measures economic, environmental and social performance. A company that reports under GRI's *Sustainability Reporting Guidelines* should include the following elements in a report that complements and only draws selectively from the financial statements:

- vision and strategy;
- profile;
- governance structure and management systems; and
- performance indicators.

The guidelines include extensive lists of economic, environmental and social performance indicators from which companies can choose those that are most relevant to their circumstances and impacts.

The guidelines also state that 'Valuing intangible assets – human capital, environmental capital, alliances and partnerships, brands, and reputation – must complement the valuation of conventional tangible assets...'

GRI is developing:

- technical protocols on indicator measurement. 'Each protocol addresses a specific indicator or set of indicators by providing detailed definitions, procedures, formulae and references to ensure consistency across reports'; and
- sector supplements to its guidance for the following sectors: financial services (social performance), tour operators, automotive, and telecommunications.

4.8.3 The desired result

The immediate object of GRI's *Sustainability Reporting Guidelines* is 'to assist reporting organisations and their stakeholders in articulating and understanding contributions of the reporting organisations to sustainable development.' The broader objective is 'to help direct private sector activity toward outcomes that are socially and environmentally, as well as economically, beneficial.'

GRI also argues that companies that comply with its guidelines are acting in their own best interests. There are 'linkages between sustainability performance and key value drivers such as brand image, reputation, and future asset valuation'. Sustainability reporting gets departments of the company that wouldn't otherwise do so talking to one another and gives warning of 'potentially damaging developments before they develop into unwelcome surprises.' It may also 'reduce volatility and uncertainty in share price for publicly traded enterprises, as well as reducing the cost of capital ... avoiding major swings in investor behaviour caused by untimely or unexpected disclosures.'

These arguments are developed in an annex to the guidelines: ‘linkages between sustainability and financial reporting’. Here it is explained that ‘sustainability reporting has the potential to provide critical information for business analysis that is normally absent from financial reports. This information complements financial reports with forward-looking information that can enhance the report users’ understanding of such key value drivers as human capital formation in the firm, corporate governance, management of environmental risks and liabilities, and the capacity to innovate.’

The annex states that ‘two key components of internal business analysis are: 1) understanding the external environment in which the company conducts its business; and 2) assessing the elements that underpin the company’s competitive advantage. Sustainability information is relevant to both.’ The annex concludes that, ‘As the business case for sustainable practices becomes increasingly clear, sustainability reporting offers real value to those whose business is to assess the current financial health of companies and anticipate future performance.’

4.8.4 Responsibilities

Responsibility for implementing the guidelines falls on managers. However, GRI is supported by a wide range of patrons and benefactors including businesses, accounting firms, professional bodies and non-governmental organisations, who are expected to encourage adoption of the guidelines.

4.8.5 Motivation

Managers will be motivated to implement the guidelines (1) if they support sustainability and believe that GRI contributes to it, (2) by the attractions of a lower cost of capital and less volatile share price, and (3) by the benefits to the business of an improved reputation.

The guidelines also give a list of ‘trends ...that have fuelled GRI’s swift progress’, which may be regarded as motives for adopting GRI or supporting its adoption. These include:

‘Expanding globalisation: ... [A]ll parties – including corporations – are seeking new forms of accountability that credibly describe the consequences of business activities wherever, whenever, and however they occur.’

‘Search for new forms of global governance: ... The borderless global economy requires equally borderless governance structures to help direct private sector activity toward outcomes that are socially and environmentally, as well as economically, beneficial... A key theme in all these emerging governance models is the demand for higher levels of transparency.’

‘Reform of corporate governance: Pressures on corporations to establish and maintain high standards of internal governance are accelerating... Effective corporate governance depends on access to relevant, high-quality information that enables performance tracking and invites new forms of stakeholder engagement.’

‘Rising visibility of and expectations for organisations: ... Several recent high-profile events have exemplified the risks to reputation and brand image associated with poor sustainability management.’

‘Measurement of progress toward sustainable development...’

‘Governments’ interest in sustainability reporting...’

‘Financial markets’ interest in sustainability reporting... The financial industry slowly but steadily is embracing sustainability reporting as part of its analytical toolkit, [and there is] growing demand for social and ethical funds...’

‘Emergence of next-generation accounting...’

4.8.6 Practical difficulties

The guidelines stress the importance for businesses of reporting information that will be credible to a wide range of sceptical stakeholders and note that ‘in response to stakeholder expectations, reporting organisations have adopted a variety of strategies for enhancing the credibility and quality of sustainability reports.’ These include ‘stakeholder consultation panels, strengthened internal data collection and information systems, issue-specific audits by appropriate experts, internal audits of data collection and reporting systems, use of the GRI *Guidelines* as the basis for report preparation (and indicating so), reviews and commentaries by independent external experts, and use of independent assurance processes for sustainability reports.’

The guidance recommends that ‘reports include a statement of:

- the reporting organisation’s policies and internal practices to enhance the credibility and quality of its sustainability report; and
- the reporting organisation’s policy and current practice with regard to providing independent assurance about the full report.’

Also, ‘GRI encourages the independent assurance of sustainability reports.’

Nevertheless, in relation to assurance provision and in the development of performance indicators across a wide range of activities, GRI is keen to stress that it does not have all the answers and is engaged in a process of development and learning. It has set up a Verification Working Group to consider the options on this issue.

4.8.7 Monitoring progress

GRI is perhaps unique among proponents of new reporting models in that it is committed to monitoring and learning from experience in implementing its proposals and has a structure in place to ensure that it does so.

Progress on the adoption of GRI is reported on the GRI website. In September 2003, the website listed 15 organisations from around the world that report in accordance with GRI and 313 that in at least some respect disclose information recommended by GRI.

The website gives further information for each company.

This data shows the same results overall as other surveys of non-financial disclosures: many companies are producing some degree of discretionary information, but each company is doing something rather different from the rest apart from the 15 organisations that are in full compliance with the GRI guidelines.

4.9 The Brookings Institution

The Brookings Institution’s recommendations are focused on the problem of reporting intangibles and put forward a framework to allow companies to move towards reporting the values of all relevant intangibles.

The Washington-based Brookings Institution formed a Task Force on Intangibles in 1998. Its report, *Unseen Wealth: Report of the Brookings Task Force on Understanding Intangible Sources of Value* ('Unseen Wealth'), was published in 2001. The Task Force commissioned a study by Professor Baruch Lev, *Intangibles: Management, Measurement, and Reporting*, also published in 2001. Similar ideas to the analysis and proposals in these two reports can also be seen in the *Study on the Measurement of Intangible Assets and Associated Reporting Practices* prepared for the European Commission (2003), to which Professor Lev contributed.

4.9.1 The problem

The Task Force's report notes that 'economic growth is no longer being driven primarily by investments in physical assets, but instead by investments in intellectual, organizational, institutional, and reputational assets. The factors that have become most important to business success and economic growth in developed economies in the twenty-first century are "intangible," or "non-physical".' However, there is a 'large and growing discrepancy between the importance of intangible assets to economic growth and the ability to identify, measure, and account for those assets [and this] is a serious potential problem for business managers, for investors, and for government.' Overall, 'the lack of good information about the most important value drivers in individual firms, and in the economy as a whole ... may ... be producing a serious misallocation of society's resources that could be corrected with better information.'

Unseen Wealth argues that 'The most important impediments to development of better information on intangibles are the cognitive barriers – the lack of business models that accurately and effectively describe productive activities in the New Economy and the lack of a common vocabulary with clear, consistent, and robust definitions of the factors that go into such productive activity... The paucity of good robust models and consistent vocabulary for intangibles ... stands in the way of development of performance or measurement data that would be comparable across firms.'

In *Intangibles: Management, Measurement, and Reporting*, Professor Lev argues that the poor reporting of intangibles leads to the following harmful consequences:

- 'Excessively high cost of capital...'
- 'Systematic undervaluation by investors of the shares of intangibles-intensive enterprises...'
- 'Excessive gains to officers of R&D-intensive companies from trading in the stocks of their employers (insider gains)...'
- 'Continuous deterioration in the usefulness of financial information, possibly leading to volatility and excessive riskiness of securities.'
- 'Manipulation of financial information...'

Professor Lev is critical of sweeping calls for more disclosure to solve the problem. 'The suggestions generally advanced, such as a disclosure of more non-financial measures, are haphazard and lack consistency, and the calls for a period of experimentation with improved measures are, in my opinion, vacuous... More information about intangibles will not fall like manna from heaven just because writers or committees call for it.'

4.9.2 The solution

Unseen Wealth argues that ‘progress can and should be made in developing better information about intangibles and their impact on the valuation of firms’. It identifies three ‘levels’ of intangible (from the point of view of measurement problems):

1. assets that can be owned and sold;
2. assets that can be controlled but not separated out and sold (e.g. reputational assets, business processes);
3. intangibles that may not be wholly controlled by the firm (e.g. human capital, relationship capital).

For level (1) intangibles, ‘it should be possible to develop useful information about the costs incurred by firms in developing assets in this category, and probably also to develop information about the value of these assets.’ However, ‘many of the factors relevant to the value of level (2) and level (3) intangibles are probably not directly measurable, because they cannot be clearly separated from other related factors. Thus the best one can hope for at present is to identify and develop indirect indicators, or clusters of indicators, to help understand the roles played by these factors in productivity and wealth creation’.

Unseen Wealth states that ‘users of financial information have made it clear that what really matters to them is the value of intangibles in a firm (rather than the cost of acquiring or developing them) and what are the so-called value drivers that will help to produce future cash flows.’ The financial reporting model should ‘begin to move toward a value-based system of accounting for corporate assets – both tangibles and intangibles – that would supplement the current cost-based system.’

In *Intangibles: Management, Measurement, and Reporting*, Professor Lev proposes a two-stage solution to help move financial reporting in the direction indicated by the Task Force. The first stage is ‘a satellite information system’ to financial reports. This would focus on the concept of a ‘value chain scoreboard’ (for which the author was in the process of applying for a trademark). The scoreboard would give **quantitative, standardised** and **relevant** measures for each of the three stages of the value chain. These are:

1. ‘the discovery of new products or services or processes’,
2. ‘the development phase of these discoveries and the establishment of technological feasibility’,
3. ‘the commercialization of the new products or services’.

Companies may also disclose **qualitative** information, but in an annex to the scoreboard.

The information would be **standardised** to ensure that it is comparable across businesses. The standards would not mandate disclosures but be ‘standards’ in the sense of providing a common approach. Professor Lev argues that once such standards are in place, disclosures will follow voluntarily. ‘Enterprises with good news ... will start disclosing – in effect motivating others to join ranks. No news is bad news in capital markets; silence is penalised.’

Relevant disclosures here mean disclosures that are relevant to users. Indeed, the measures on the scoreboard ‘should be confirmed by empirical evidence as relevant to users (generally by establishing a significant statistical association between the measures and indicators of corporate value such as stock return and productivity improvement).’

The second stage of Professor Lev’s plan is changes to mandatory accounting standards. He proposes ‘the recognition as assets of all intangible investments with attributable benefits that have passed certain prescribed technological feasibility tests... Once asset recognition commences ... all the project-related previously expensed R&D should also be recognised as assets... A strict periodic impairment test ... should be applied as a safeguard against overvaluation.’ The object of these changes would be to match income and expenditure better in company accounts.

4.9.3 The desired result

The Task Force’s proposals in *Unseen Wealth* are intended to bridge the gap between the importance of intangibles in the modern economy and the accounting for them. Users would also have the information they want on the value of intangibles (and incidentally of tangible assets). ‘More comprehensive and more reliable information about intangibles in [high-tech] companies would help reduce the problems of information asymmetry and the associated costs in market volatility for the sector as a whole. Moreover, better information would lead to better decisions about which specific companies and ideas should be funded and which should not. This, in turn, would help to restore overall market confidence.’ The government would have better information on which to base its decisions. Society as a whole would benefit from a more rational allocation of resources.

Professor Lev believes that his proposals would reduce the cost of capital, remove the systematic undervaluation of intangible-intensive companies, prevent insider gains for the officers of R&D-intensive companies, reverse the deterioration in the usefulness of financial information, and remove one of the ways of manipulating financial information.

4.9.4 Responsibilities

Responsibility for implementing the Task Force’s recommendations falls to the US government, the SEC, FASB, the accounting profession and management.

Although managers will ultimately be responsible for implementation of standards and guidelines, the Task Force believes that ‘Market incentives alone will probably not lead to the development of consistent, verifiable metrics and measurement standards because the costs associated with such development outweigh the potential reduction in the cost of capital for any one firm... One can imagine hundreds of thousands of snippets of information that firms might selectively, and on their own initiative, provide to investors... But such information is just fog if it is not reported regularly and collected in a consistent and sensible way... Moreover, such data would also be vastly more informative if they could be compared to industry benchmarks that were also collected regularly and consistently.

‘Moreover, any effort to develop comparable data is likely to be hampered by the “public goods” problem: even though it would be in everyone’s interest to have better data, it is not in any single person’s interest to expend the resources to collect and develop the data.’

The government therefore needs to act. It 'should actively:

- facilitate the convening of all interested stakeholders;
- help to finance the research necessary to monitor and evaluate experimentation in measurement and disclosure; and
- foster the promotion of voluntary guidelines that would increase the availability of comparable and verifiable information about business investments in R&D, in structural or organizational capital, and in human capital.'

The Task Force recommends that the researchers 'should work with participating firms to develop and test [business] models that more accurately describe the relationships among the various inputs and outcomes measures and to link the primary inputs to intermediate inputs and, ultimately, to financial performance and other measures of total value creation.'

The SEC and FASB should monitor the government-supported research project, 'with an eye toward identifying reliable performance indicators that should be included in the disclosures required of publicly traded companies... We also propose that the SEC expand the safe harbour protections for firms that voluntarily disclose more information about their intangibles and value drivers... As reliable, auditable, and verifiable performance indicators are developed, [the SEC and FASB] should consider whether they should be included in the disclosures required of publicly traded companies, and if so, how and in what form.'

Responsibility for implementing Professor Lev's proposals falls to FASB and managers. FASB has to develop (non-mandatory) standards to ensure that disclosures are comparable; managers have to implement the standards. FASB also has to amend its mandatory accounting standards in due course.

4.9.5 Motivation

The Task Force's assumption seems to be that the discrepancy between accounting and economic reality is so large that all concerned will agree that the position is intolerable and that something (i.e. the Task Force's plan) needs to be done about it for the benefit of society as a whole. However, the Task Force also provides an extensive analysis of the motivational obstacles to reform.

It states that 'among corporate executives there is widespread resistance to increasing the *required* disclosure in this area ... firms are aware that additional disclosures can help them when the information is good, but can hurt them when the information is not so good. Hence the business community tends to be wary of changes that will commit them to any form of expanded disclosure.'

Unseen Wealth provides a detailed analysis of investment community concerns.

1. '*Resistance to changing paradigms.* Securities analysts who ... use complex quantitative models to assess value and make buy or sell recommendations, have generally learned to look at firms in certain ways and resist radically rethinking the tools they use...'
2. '*Proprietary methods.* Some securities analysts ... have developed their own models and metrics for assigning value to the intangible assets in firms ... they are likely to regard their valuation models as a source of personal competitive advantage...'

3. *'Selective access to information.* A final reason why many members of the financial community, especially analysts representing large financial institutions, have not been especially enthusiastic about or supportive of efforts to develop better performance indicators and enhanced disclosure requirements ... is that they have often had special access to corporate executives.'

In spite of these motivational obstacles, the Task Force concludes that 'most of the objections of the various parties can be appropriately addressed principally through governmental and regulatory action.'

In *Intangibles: Management, Measurement, and Reporting*, Professor Lev provides an analysis of the groups that would benefit from reform.

'Corporate managers and their shareholders. Evidence indicates that intangible investments are associated with excessive cost of capital... The excessive cost of capital, in turn, hinders investment and growth. Managers and investors should, therefore, be interested in mechanisms aimed at alleviating the excess cost of capital.'

'Investors and capital market regulators. Research documents the existence of above-average information asymmetry ... in intangibles-intensive companies. Economic theory suggests that ...[such asymmetries] lead to undesirable consequences, such as systematic losses to the less informed parties and thin volume of trade.'

'Accounting standard setters, corporate boards. Empirical evidence indicates that the deficient accounting for intangibles facilitates the release of biased and even fraudulent financial reports. This should obviously be of concern to regulators of financial information ... and to corporate board members who rely heavily on accounting-based information to monitor managerial activities.'

'Policymakers. The information from corporate financial statements is a major input into the national accounts and policy deliberations. The various intangibles-related deficiencies in financial information adversely affect public policymaking in key areas, such as the assessment of fiscal policy ... supporting innovation, optimal protection of intellectual property ... and the desirability of industrial policy.'

Professor Lev also provides an analysis of different groups' reasons for opposing reform. 'The main reason for the intangibles' information failure lies ... in the complex web of motives of the major players in the information arena: managers, auditors, and well-connected financial analysts.'

Managers. (1) 'The GAAP-mandated expensing of practically all investments in intangibles ... is a recipe for inflating future reported profitability and growth and ... serves to protect managers against embarrassments... Given the high risk of intangibles, the probability of acquired R&D or technology under development to disappoint expectations is not insignificant... An immediate expensing obviates the need to provide explanations in case of failure.' (2) 'Economic theory postulates that the disclosure of relevant information is rewarded by lower cost of capital... In reality, there is still only scant evidence of a link between improved disclosure and cost of capital, and the estimated reduction in cost of capital is very modest. In my opinion, this evidence is too fragile to counter the strong incentives to inflate future profitability and avoid embarrassments.' (3) Non-disclosure also allows managers to enjoy insider gains.

Auditors. 'Public accountants ... mainly concerned with shareholder lawsuits, are comfortable with accounting rules that eliminate risky assets from the balance sheet that, in the occurrence of a company failure, may draw lawsuits by irate shareholders.'

Analysts. ‘Financial analysts ... particularly well-connected ones, believe that they obtain from managers (via conference calls, background briefings, and so on) sufficient information about firms’ innovation activities. In fact, public disclosure in financial reports of such information may strip them of privileged information.’

However, once FASB has established standards, managers will also be motivated by market forces. Companies with good news will start making the proposed disclosures and be rewarded by the market (with a higher and less volatile share price); other companies will follow suit as they will not wish to be punished by the market for non-disclosure.

4.9.6 Practical difficulties

A large number of practical issues are anticipated and are intended to be tackled through government or regulatory action. For example, conceptual, technical and measurement problems are to be dealt with through continuation of the research begun by the Task Force and Professor Lev. Concerns about commercially sensitive disclosures will be resolved through FASB and SEC requirements. Liability fears will be addressed through enhanced safe harbour protections.

4.9.7 Monitoring progress

We are not aware of any formal monitoring of progress on the Brookings Institution proposals, nor of any US government-supported research or SEC and FASB initiatives of the type urged by the Task Force and Professor Lev.

4.10 ValueReporting™

The key idea in ValueReporting™’s wide-ranging proposals is greater transparency; this leads among other things to recommendations that businesses should report performance on all the measures they use internally and that industry-specific disclosure standards for non-financial information should be developed on a voluntary basis.

The ValueReporting™ Revolution: Moving Beyond the Earnings Game (*The ValueReporting™ Revolution*) by Robert G. Eccles, Robert H. Herz, E. Mary Keegan and David M. H. Phillips was published in 2001. The authors were all at the time with either the US or UK firms of PricewaterhouseCoopers. Since publication, Mary Keegan has become chairman of the UK Accounting Standards Board and Robert Herz chairman of the US Financial Accounting Standards Board. *Building Public Trust: The Future of Corporate Reporting* (*Building Public Trust*) by Samuel A. DiPiazza Jr and Robert G. Eccles of PricewaterhouseCoopers in the US (published in 2002) takes *The ValueReporting™ Revolution* as one of its foundations.

4.10.1 The problem

According to *The ValueReporting™ Revolution*, ‘the corporate reporting model has failed those whom it intends and ought to serve best. Neither the companies that report, nor the investors who listen, fare well... The model has not even begun to keep pace with the extraordinary changes in how executives manage their companies – in strategy, organization, technology, and human resources... The lack of a broad set of performance information has contributed to inaccurate stock prices and extreme volatility. Analysts and investors don’t get the information they need from companies and rely instead on rumor, innuendo, and gossip... Companies don’t provide timely information... [They] barely touch the tip of the iceberg in providing the information investors want on the risks they take to create value.’

The authors report a survey suggesting that neither investors, analysts, or preparers believe that ‘financial reports [are] very useful in communicating the true value of companies’. As a result, executives believe their companies are undervalued. ‘On top

of this, managers, analysts, and shareholders feel themselves trapped in a short-term earnings game that none of them really likes, but all see no choice but to play. This results in a capital market too focused on the short term and lacking the information it needs to properly establish value.’ The earnings game focuses the attention of managers and analysts on quarterly earnings and whether the business will meet forecasts. This encourages short-termism and manipulation of the results, and distracts managers from vital non-financial measures.

The authors set out ‘The Seven Rules of the Earnings Game’:

1. ‘Deliver a track record of consistent earnings growth.’
2. ‘Manage earnings expectations carefully.’
3. ‘Slightly beat earnings expectations.’
4. ‘Make business decisions to meet or beat expectations.’
5. ‘Hammer stocks that fail to meet expectations.’
6. ‘Listen carefully for the whisper number.’
7. ‘Hammer stocks that fail to meet the whisper number.’

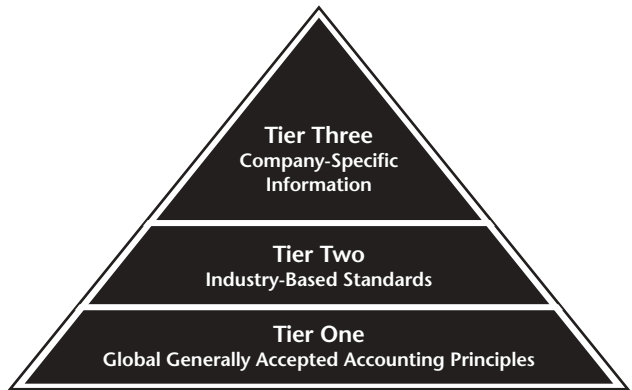
The authors argue that ‘The market is in the dark – or at least the dim – when it comes to establishing stock prices. It simply doesn’t have or can’t get the kind of information it needs to value companies properly or accurately. The results? Extreme volatility. Arguments about the relative valuations of Old Economy and New Economy companies. And an unhealthy concentration of value in a small number of companies of both types – typically those for which a great deal of information is available. Heed the consequence: a less than optimal allocation of capital in terms of the trade-off of risk and return... When it comes to setting market prices, chat room rumors and gossip, earnings surprises, external events, and market sentiment now outweigh in importance the kind of information companies currently provide.’

As its title indicates, *Building Public Trust* is primarily about rebuilding public trust after recent high profile corporate failures, principally in the US. ‘Public trust has been shaken in the institutions on which ... value creation [in capital markets] depends... The challenge now is to institute the necessary reforms to ensure that public trust does not disappear, and the foundation for those reforms lies in corporate reporting.’ Unfortunately, ‘events all over the world have shaken public confidence in the quality of reported information.’ Otherwise, the analysis of current problems in *Building Public Trust* is essentially the same as in *The ValueReporting™ Revolution*. ‘Every aircraft in the world,’ it comments, ‘would be grounded if air traffic control relied on the same type of system that companies use today to report their information... Current reporting formats provide too little too late...’. What is more, ‘For various reasons, management and boards are not consistently making available information that they know investors would want.’

4.10.2 The solution

According to *Building Public Trust*, the overriding need is for ‘a spirit of transparency. Corporations have an obligation to provide willingly to shareholders the information needed to make decisions.’

Figure 5: Building Public Trust



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The book sets out a three-tier pyramid of corporate transparency:

1. 'A set of globally generally accepted accounting principles.'
2. 'Standards for measuring and reporting information that are industry-specific, consistently applied, and developed by the industries themselves.'
3. 'Guidelines for company-specific information such as strategy, plans, risk management practices, compensation policies, corporate governance, and performance measures unique to the company.'

ValueReporting™ would provide the information for tiers two and three in the pyramid. Businesses should 'report information to the market on all the measures they use internally to manage. And that encompasses dimensions that other stakeholders [i.e. other than investors] regard as important as well, including social and environmental responsibility.' Putting this solution into practice constitutes the revolution of *The ValueReporting™ Revolution*.

Figure 6: ValueReporting™ Framework

Market Overview	Strategy	Value Creating Activities	Financial Performance
<ul style="list-style-type: none"> Competitive Environment Regulatory Environment Macro-economic Environment 	<ul style="list-style-type: none"> Goals and Objectives Organisational Design Governance 	<ul style="list-style-type: none"> Customers People Innovation Brands Supply Chain Environmental, Social and Ethical 	<ul style="list-style-type: none"> Financial Position Risk Profile Economic Performance Segmental Analysis

The above framework is an excerpt from the ValueReporting™ Review 2003. © PricewaterhouseCoopers LLP. 'ValueReporting' is a PricewaterhouseCoopers LLP trade mark and is registered in the UK, the USA, Singapore and Taiwan.

This does not mean that ValueReporting™ is simply a matter of reporting externally what is used internally. Managers also have to establish what are the right measures to run the business *and* to compare their measures with what the market views as important. These points are reflected in a four-step process:

‘Step 1: Construct a business model that shows the cause-and-effect relationships among key value drivers; then identify the most meaningful measures for them.’

‘Step 2: Develop new measurement methodologies if they don’t already exist.’

‘Step 3: Validate the business model and the measures through testing and use.’

‘Step 4: Compare management’s view with the market’s view on what measures are important.’

The construction of a business model underpins everything else and the authors of *The ValueReporting™ Revolution* advocate models that identify quantified relationships between indices of value drivers (such as product and service quality, employee competence, employee motivation, delivery performance and customer satisfaction) and shareholder values, via financial measures such as sales value.

ValueReporting™ specifies certain key disclosures for companies. These include a ‘market overview’ and a ‘value strategy’.

The market overview is ‘management’s take on external market forces, those operating within the company’s own industry and the broader forces of the overall economy. It also includes management’s views on where the market is headed.’

The value strategy ‘describes in as much detail as possible, without giving away the store, how a company will compete in its particular marketplace. This description should explicitly point out the company’s competitive strengths and how it will exploit them. The value strategy also identifies the company’s weaknesses, and how it will correct or compensate for them. Because strategies become real only when grounded in plans, objectives, and targets, the company should report on these as well.’ *The ValueReporting™ Revolution* prescribes in very general terms disclosures on financial performance, capital structure, risk management, governance and management.

ValueReporting™ also calls for disclosure of measures on intangible assets and non-financial value drivers. To make these measures ‘as meaningful as financial measures, standards will have to be created for them... Then investors can at least begin to make apples-to-apples comparisons between companies along such key measures as market share, customer retention, speed-to-market, employee turnover, and intellectual capital.’ The authors argue for ‘standards developed by company-led, industry-based consortia... [rather than] universal standards that would apply across all industries.’ This is because ‘it is highly doubtful that all industries could ever agree on common valid measures for such value drivers as intellectual capital or customer penetration.’

The authors of *The ValueReporting™ Revolution* also argue that the solution to ‘the Earnings Game’ is to ‘Eliminate The Earnings Game altogether. To do this, two things must happen. First, make quarterly earnings releases a nonevent by providing earnings and other financial information on a monthly, weekly, or even daily basis – whatever period makes sense... Second, dramatically reduce the attention paid to earnings or cash flow ... for short periods of time.’ The proposals described above are designed to do this.

The ValueReporting™ Revolution proposes that the principal method of delivery of information should be changed to electronic to allow users 'to look behind and beneath the summary figures so that they can understand where the numbers come from. Essentially, they want the reports that management gets... Through drill-down capabilities, companies could easily provide such detail today, with built-in levels of access geared to the individual's information needs.' The book states that 'the ... technology for the ValueReporting revolution' is XBRL.

Building Public Trust identifies an extended role for auditors in the new reporting model. Auditors already report on Tier One information – the financial statements. 'In the future, investors will benefit if assurance extends to tiers two and three. This will require assurance on a broader and deeper set of information, more frequently provided, and on a more timely basis.'

4.10.3 The desired result

According to *The ValueReporting™ Revolution*, once 'managers begin reporting performance on all the measures they use internally, they will [cease] to be the pawns in The Earnings Game'. This is because, although 'current earnings are certainly an important leading indicator of future earnings ... so are measures like delivery performance, service quality and customer satisfaction. If the market had information on these other leading indicators, it could put current earnings ... into the proper perspective.' This will allow earnings to fulfil its proper role. 'Longer-term investors need access to information on non-financial performance and intangible assets, the basis for how value will be created. Of course, value must eventually be turned into earnings and cash flow. But when investors have access to all – and that means all – relevant information, bottom-line measures will resume their original purpose: to tell investors how well the company has done rather than predict how well it may do in the future.'

Rectifying the present state of affairs will lead to stocks being priced more accurately and with less volatility. In a prefatory 'Note for the Second Printing' it is stated that adoption of the book's proposals 'will ensure that stocks are more sensibly priced. Both excessive optimism ... and excessive pessimism ... will be replaced by more rational investment decisions, both by companies and by investors.' The authors point out, though, that 'It would be naive to assert that even total transparency regarding all the performance measures used to manage the company would eliminate volatility. It won't.' Also, 'ValueReporting is not a silver bullet for guaranteeing more value for shareholders ... ValueReporting can guarantee, however, that a company's stock price will be closer to its intrinsic value.' However, the book cites a PwC survey of institutional investors and sell-side analysts suggesting that better disclosure will result in 'increased management credibility, more long-term investors, greater analyst following, improved access to share capital, and higher share values.'

Building Public Trust takes the same approach as the earlier book.

4.10.4 Responsibilities

ValueReporting™ assigns responsibility for implementing its proposals to several parties, but especially to managers. It is a double responsibility: to implement the changes on behalf of the company (including the changes to the company's internal reporting based on its business model) and to agree with other companies in the same sector guidelines or standards for disclosure. 'Regulators, professional standard setters, and academics simply cannot *initiate* new reporting practices for new measures without support from the business community. Until executives take the lead, nothing much ... will happen.' 'Top executives must take the primary responsibility.' Non-executives also have a share

of the responsibility, though. 'The board of directors, which represents the interests of shareholders, should ensure that investors get the information on these measures they need ... [They] must ultimately make it happen. It's an integral part of their responsibility to shareholders.' And, 'in some cases, those who serve on audit committees will play a key role.'

The authors of *The ValueReporting™ Revolution* argue that 'standards would best be developed through a market-driven process'. To start with: 'a few leading companies in each industry would agree that developing standards is the right thing for them to do...' This is the first step in an eight-point plan, including consultation with users. 'We believe that [financial statements and other information on key performance measures and business value drivers based on a set of standards] can be developed through a modified market solution model that involves collaboration among companies, users, and accounting firms. Initially, this should be done through broad principles and experimentation. Eventually, if enough agreement can be reached on measurement definitions and methodologies, this experimentation will evolve into more formal standards with regulatory blessing...'

What of the regulators' role? 'Assume that standards are developed. What will the external regulators do about them? In all candor, regulators will probably prick up their ears and eventually get involved... As standards become more refined and widely accepted, most companies will recognize that they put themselves at a competitive disadvantage if they don't adopt them.'

Investors too will have a part to play. 'The more quickly and aggressively investors demand their full information rights, the sooner the revolution will be won.'

Accounting firms 'can and should work with their clients to:

- Identify all the key components and value drivers
- Become experts on the business processes and related controls surrounding the measurement of value drivers
- Specify the relationships among value drivers (the 'business model')
- Develop methodologies for measuring value drivers
- Participate in or even organize the industry consortia that will turn the methodologies into industry standards
- Encourage their clients to report information on the measures in as timely and detailed a fashion as possible...'

'For years, accountants have had a "stick to the audit" mentality, which has meant not challenging their clients except on accounting and reporting standards. They must transform this attitude into a strong stance with clients about the benefits of doing more than regulations require and the necessity to meet the information needs of shareholders.'

The book concludes with 'A Call to Arms' addressed to various parties.

'Regulators. Lend your wisdom and good counsel...'

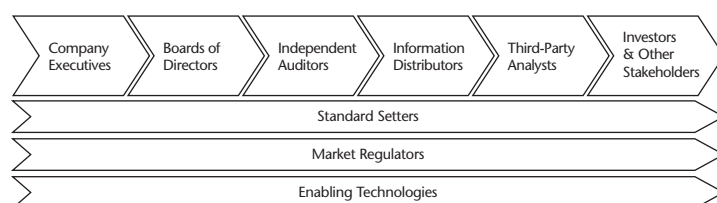
'Institutional investors. Demand the information you need and deserve...'

'Boards of directors. The revolution needs strong leadership. It should and must come from you. You really have no choice but to lead.'

'Corporate executives. Enlist today. Prove your worth. Get full credit for the value you create. Deep in your heart, you know it is right.'

The allocation of responsibilities in *Building Public Trust* is consistent with the earlier book, although the responsibilities of analysts are emphasised and all the responsible parties are presented as playing roles in the 'corporate reporting supply chain'.

Figure 7: The Corporate Reporting Supply Chain



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4.10.5 Motivation

According to *The ValueReporting™ Revolution*, managers should be motivated by the prospect of 'increased management credibility, more long-term investors, greater analyst following, improved access to share capital, and higher share values' as well as reduced share-price volatility and the opportunity to escape from 'the earnings game'.

However, the book also recognises that 'there are strong, firmly constructed barriers to speeding up the process of developing a new reporting and disclosure model... Most corporate executives instinctively oppose reporting on new dimensions of performance. They feel that the costs of greater disclosure outweigh the benefits, particularly if they have to disclose first.' Also, if managers disclose the information called for, they 'will be held accountable if their performance is poor' and 'Although they don't like The Earnings Game, managers don't want to start a new game until all the players agree to a new set of rules...'

The authors use fear as well as hope to persuade managers. 'Companies that join the revolution early and take meaningful, productive steps toward better disclosure can gain enormous competitive advantages... They will avoid the worst only if they conscientiously and completely revolutionize themselves.' Also, 'if companies don't provide the information others seek, someone somewhere will. By providing the information itself, the company can ensure the information's accuracy and put it in an integrated, balanced context.'

The persuasive force of inevitability is also invoked. 'The revolution in performance reporting must happen... It is *inevitable* that a key contribution to solving a problem deeply embedded in the capital markets will come from the product markets. The market hungers for more – and more useful – information, delivered more quickly than ever. It *will* be satisfied.'

Fear of the regulators is another incentive. 'Given the inevitability of such change... companies should ... lead the process, and stay one step ahead of the regulators. After all, the market sees the need for the change and will force it to happen, with or without regulatory solutions... [A]n external regulatory solution would more likely lead to a rules-based approach, whereas a market-driven, self-regulatory solution will more likely lead

to a principles-based approach.’ If industry-based standard-setters do their job well, therefore, regulation is likely to be lighter. However, regulators are not expected to be actively involved in the near future. ‘Why do we need a market-driven solution?... First, without the voluntary participation of companies, no standards will emerge unless the regulators intervene directly. This seems unlikely in the short term as regulatory bodies worldwide have their hands full with a backlog of purely historical financial accounting matters.’

Little hope is also placed in investors. ‘Institutional investors ... certainly want more information. But they want it all to themselves in hope of gaining a proprietary advantage. Thus, they seek to get this information in private meetings with companies... Sell-side analysts ... have no interest in changing the game at all, given the central part they play in it. Their importance, and no doubt their salaries, would certainly shrink if investors could get the information they need directly from companies, and if quarterly earnings announcements became largely irrelevant.’

4.10.6 Practical difficulties

The authors of *The ValueReporting™ Revolution* accept that ‘some information lacks sufficient reliability for it to be communicated to the market. When making internal decisions, managers can take a bit more latitude with lower-quality information... Until companies can close the Quality Gaps, large Reporting Gaps will – and should – appear...’

Building Public Trust effectively avoids the major problems by building them into the model as constraints; they cannot, therefore, be obstacles to implementation. Thus, ‘certain disclosures might put the company at a competitive disadvantage. They might be easily misleading. Some information might be unreliable, too detailed to be clarifying, or ... too costly to assemble.’ The book also acknowledges the need for safe-harbour legislation and concludes that companies should ‘weigh the risks and costs [of disclosure] against the benefits’.

4.10.7 Monitoring progress

PwC has had a website and an annual report devoted to ValueReporting™ for several years. It also provides supporting services and associated events such as, in the UK, the PwC Corporate Reporting Awards: ‘Building Public Trust’.

The website (www.valuereporting.com) ‘will continuously refresh and replenish the examples of better disclosure practice as companies set them. The website will also make future reports on the revolution’s progress more timely and accessible and will include the PricewaterhouseCoopers annual *ValueReporting Forecast*.’

Trends in Corporate Reporting 2004: Towards ValueReporting™ (published in 2003) is the latest in PwC’s series of annual surveys of best practice, mainly in the form of reproduced extracts from company accounts with a commentary highlighting key points. PwC does not claim that the companies covered in the survey have completely followed the ValueReporting™ approach. Indeed, it notes that, ‘while the benefits of greater transparency should be apparent to everyone, progress has been slow’.

The extracts given in the survey show best practice in particular respects. PwC asks, ‘is any single company providing a truly comprehensive picture of their corporate performance today?’ and answers, ‘probably not’. But the survey shows that forward-looking information and non-financial information are being reported by at least some companies, and also how diverse that information is.

4.11 The Hermes Principles

The Hermes Principles give an investor perspective on business reporting, emphasising the importance of open communication with shareholders on key issues and the central role of discounted cash flows in assessing business performance.

The Hermes Principles: What Shareholders Expect of Public Companies – and What Companies Should Expect of Their Investors is a booklet by Tony Watson and David Pitt-Watson of Hermes Pensions Management Limited, issued in 2002, that sets out the company's views on the topics indicated in its title. The booklet concerns corporate practices generally, rather than reporting in particular, but it is unusual in reflecting a clear and pithy investor view of what companies should report.

4.11.1 The problem

The following problems are identified:

- Hermes' experience 'has provided a number of lessons about why companies often fail in their primary goal of delivering long-term value.'
- 'It is possible to demonstrate earnings-per-share growth while destroying shareholder value.'
- Encouraging the maximisation of returns on capital can detract from the creation of shareholder value.

4.11.2 The solution

The booklet states that 'Companies should seek an honest, open and ongoing dialogue with shareholders. They should clearly communicate the plans they are pursuing and the likely financial and wider consequences of those plans. Ideally goals, plans and progress should be discussed in the annual report and accounts... Companies should have appropriate measures and systems in place to ensure that they know which activities and competencies contribute most to maximising shareholder value.'

According to the Hermes Principles, investment decisions should be made, and their success judged, using 'the present value of the cash flows from investment, discounted at an appropriate cost of capital.' Indeed, Hermes expects every company to have a view about what its weighted average cost of capital (WACC) is and to disclose it.

The booklet applauds the example of Geest, which discloses its WACC in its annual report. In the company's words: 'Geest has had an inefficient balance sheet entirely funded by shareholders, and as a result we have operated with a sub-optimal WACC. As borrowings increase to fund our growth, our WACC will decrease.'

The authors also voice enthusiasm for cash-based reporting. The booklet observes that, while 'Modern financial accounting ... is a hugely important discipline ... [it] cannot measure the true value of the company.' Also, 'financial reporting disciplines often do not accurately measure or report the cash returns from any investment and hence whether WACC is being achieved... If, from time to time, companies wish to focus on [financial accounting] measures, this may be quite appropriate for managerial and motivational reasons. Companies should bear in mind that the ultimate goal is long-term shareholder value, and that this is best measured in terms of cash flow returns. We welcome initiatives by companies and their advisers to establish systems based on this measure.'

4.11.3 The desired result

‘Hermes’ overriding requirement is that companies be run in the long term interests of shareholders. Companies adhering to this principle will ... also ... [benefit] the wider economy... The purpose of the capital markets ... is to allocate resources to those companies and projects where there is a high return and away from those which have lower returns. When capital markets work effectively, they will, through this process, encourage high productivity of capital and a high level of economic growth. High capital productivity and high growth will generate long-term shareholder value and strength in the overall economy.’

Being clear about the company’s goals, and the financial, strategic and ethical disciplines by which it is managed ‘will create the best chance of a company being evaluated properly, and gaining the full benefit of access to a lower cost of capital through public capital markets, and of delivering value to its owners. This is a continuing process of providing information and correcting misinformation to ensure the fullest possible understanding of the company by the market. If a company does not communicate properly, it may not get proper credit from its shareholders, even if it is succeeding.’

4.11.4 Responsibilities

Responsibility for implementing the Hermes Principles falls on managers, but it is clear that as an investor Hermes will seek adoption of the business and reporting practices that it advocates.

4.11.5 Motivation

There is a basic presumption that the interests of managers, companies and shareholders are aligned. Managers will want to implement the proposals because companies that communicate properly will enjoy a lower cost of capital and those that don’t are likely to find their shares being inappropriately valued.

4.11.6 Practical difficulties

No practical difficulties are identified.

4.11.7 Monitoring progress

There has not been any public monitoring of compliance with the Hermes Principles.

Appendix: Conceptual frameworks of accounting standard-setters

The accounting standard-setters' conceptual frameworks are relevant to this report because they underpin the traditional reporting model, which reformers want to replace.

In practical terms, a framework is intended to provide a coherent set of principles that will guide its decisions. Such a framework serves a variety of purposes.

- By clarifying the standard-setter's objectives, it should help to ensure that it achieves them.
- Following the framework when setting standards should help to ensure consistency among different standards and to prevent the use of ad hoc arguments.
- By establishing common ground that can be taken for granted, the framework should avoid the need to be constantly debating fundamentals.
- The framework sets the context in which debate on accounting standards can take place, both within the standard-setter and between the standard-setter and other parties. Those who participate in the debate will therefore know which kinds of argument are likely to be regarded as valid and which not.
- The framework should help those who apply accounting standards to understand them and should provide them with principles that can be applied to issues not covered by standards. It should also help those who use reports prepared in accordance with accounting standards to understand them.

Three major conceptual frameworks for accounting standards are those of the US Financial Accounting Standards Board, the International Accounting Standards Board and the UK Accounting Standards Board. Of these, FASB's Statements of Financial Accounting Concepts, the first of which was issued in 1978, constitute the oldest and most extensive framework, and both the IASB's *Framework for the Preparation and Presentation of Financial Statements* (1989) and the ASB's equivalent statement are derived from it in important respects. The FASB framework is, in turn, based on general information theory, which concentrates on the role of information in decision-making. Both the FASB framework and its more recent relatives, therefore, give priority to the usefulness of information for decision-making and the characteristics of information that are supposed to follow from that.

All three frameworks are sometimes said to belong to the same family, but the thinking reflected in them has developed over the years. The most recent of them – the ASB's *Statement of Principles for Financial Reporting*, issued in December 1999 – is probably also therefore the most representative of standard-setters' current thinking and it is accordingly considered at greater length than the others below.

This Appendix looks at three key issues in the frameworks that are of particular relevance to the debate on new reporting models:

- their scope;
- what they state to be the objective of financial statements;
- certain aspects of their treatment of 'assets'.

Scope

Both FASB's framework and the IASB's are restricted to general purpose financial statements.

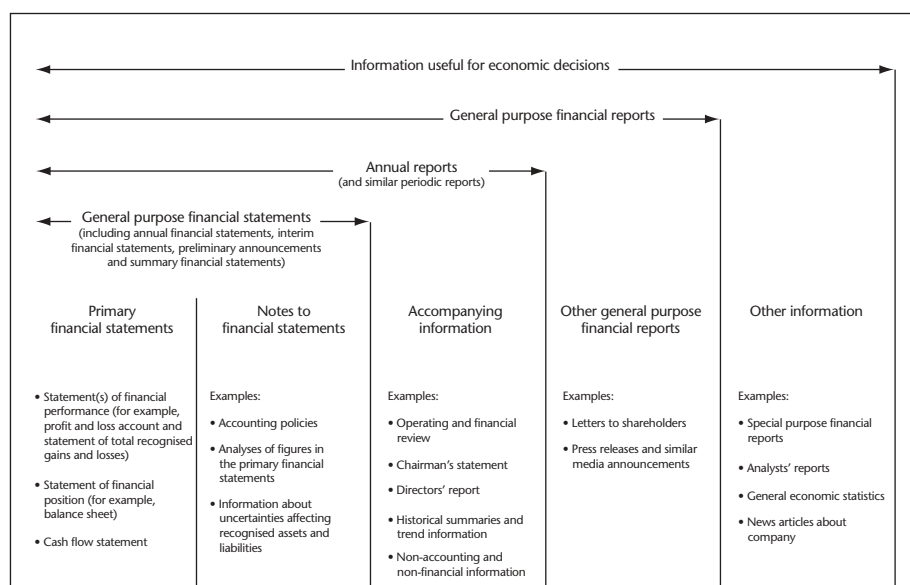
FASB's framework states that 'the information provided by financial reporting is primarily financial in nature'. According to the IASB's, financial statements 'do not necessarily provide non-financial information'.

The ASB's Statement 'sets out the principles that the Accounting Standards Board believes should underlie the preparation of general purpose financial statements.' General purpose financial statements, which include annual financial statements, are one type of general purpose financial report. 'General purpose financial reports' are negatively defined as 'financial information that, although prepared by the entity itself, is not in the form of a special purpose financial report.' 'Special purpose financial reports' are defined as 'financial information prepared by the entity itself at the behest of, and in the form specified by, persons who have the authority to obtain the information they require to meet their needs.'

General purpose financial statements are a sub-set of annual reports (and similar periodic reports), which are a sub-set of general purpose financial reports, which are a sub-set of information useful for economic decisions, some of which comes from sources other than the entity. This is set out in Figure 8.

All three frameworks, therefore, tend to exclude non-financial information. Also, they do not cover information provided to individual users, either because it would constitute a special purpose report or would not qualify as a report at all. Information in this category might include information given to institutional investors at personal meetings or to individual visitors to a website who pose questions online.

Figure 8: Categories of Financial Information



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Objective

FASB's Statement of Financial Accounting Concepts No 1, *Objectives of Financial Reporting by Business Enterprises*, gives a diffuse series of objectives, too long to reproduce here. It does not boil down the various objectives it lists – some of which one may see as being logically secondary – to a primary objective. Much of the discussion in the document, however, points towards such a process. For example: 'General purpose external financial reporting is directed toward the common interest of various potential users in the ability of an enterprise to generate favorable cash flows... Thus, the objectives in this Statement are focused on information for investment and credit decisions'. In a later statement in the framework, 'the principal objective of financial reporting' is identified as 'providing information that is useful in making rational investment, credit, and similar decisions' – but the statement on objectives does not itself identify a 'principal objective'.

The IASB Framework presents a single objective for financial statements, which is 'to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions.' It also states that, 'As investors are providers of risk capital to the enterprise, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.'

According to the FASB framework, 'the information provided by financial reporting largely reflects the financial effects of transactions and events that have already happened'. In a similar way, the IASB states that 'financial statements ... largely portray the financial effects of past events'.

According to the ASB's Statement:

- 'The objective of financial statements is to provide information about the reporting entity's financial performance and financial position that is useful to a wide range of users for assessing the stewardship of the entity's management and for making economic decisions.'
- 'That objective can usefully be met by focusing exclusively on the information needs of present and potential investors, the defining class of user.'
- 'Present and potential investors need information about the reporting entity's financial performance and financial position that is useful to them in evaluating the entity's ability to generate cash (including the timing and certainty of its generation) and in assessing the entity's financial adaptability.'

The Statement therefore excludes from its remit the information needs of users other than investors, where these do not coincide with investors' needs. And the information to be provided in order to meet investors' needs is narrowed down for the purposes of the Statement to information useful in considering the entity's ability to generate cash and its financial adaptability.

The Statement sets out the limitations of financial statements:

'Financial statements do not seek to meet all the information needs of users: users will usually have to supplement the information they obtain from financial statements with information from other sources. Furthermore, financial statements have various inherent limitations that make them an imperfect vehicle for reflecting the full effects of transactions and other events on a reporting entity's financial performance and financial position. For example:

- a) they are a conventionalised representation of transactions and other events ...
- b) they focus on the financial effects of transactions and other events and do not focus to any significant extent on their non-financial effects or on non-financial information in general.
- c) they provide information that is largely historical and therefore do not reflect future events or transactions that may enhance or impair the entity's operations, nor do they anticipate the impact of potential changes in the economic environment.'

For the purposes of this report, the key points here are that:

- the needs of users other than investors are only dealt with insofar as they coincide with those of investors;
- financial statements are largely historical.

All three frameworks, therefore, share a focus on the needs of investors, but claim that this focus will result in the disclosure of information that assists other users, and all three focus on past events.

Assets

FASB's framework sets out four 'fundamental recognition criteria' that have to be met before an item is recognised; in important respects these parallel the requirements in the IASB's and the ASB's frameworks (see below). The criteria are:

'Definitions – The item meets the definition of an element of financial statements [e.g. assets].

Measurability – It has a relevant attribute [e.g. historical cost] measurable with sufficient reliability.

Relevance – The information about it is capable of making a difference in user decisions.

Reliability – The information is representationally faithful, verifiable, and neutral.'

FASB's framework states: 'although financial information must be both relevant and reliable to be useful, information may possess both characteristics to varying degrees. It may be possible to trade relevance for reliability or vice versa, though not to the point of dispensing with one of them altogether.' By way of commentary, the FASB framework makes a distinction between financial reporting within and outside the financial statements, and describes as a 'potentially harmful generalisation' the view that 'reliability should be the dominant quality in the information conveyed in financial statements, even at the expense of relevance, while the opposite is true of information conveyed outside the financial statements.' It argues that this view, if taken to its logical conclusion, could lead to a situation where 'most really useful information conveyed by financial reporting would be conveyed outside the financial statements, while the audited financial statements would increasingly convey highly reliable but largely irrelevant, and thus useless, information.'

FASB's framework defines assets as 'probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.'

The IASB's Framework requires that: 'an item that meets the definition of an element should be recognised if:

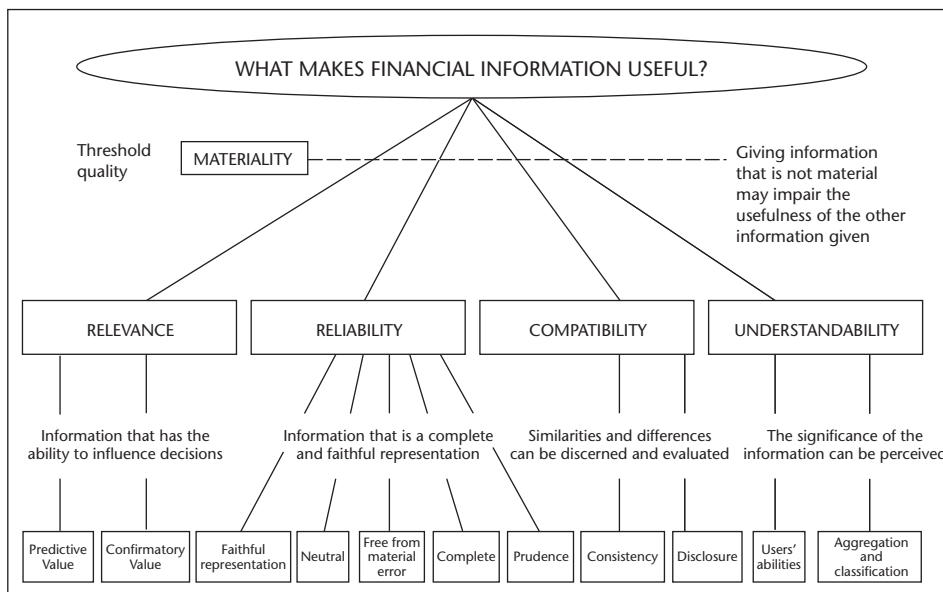
- (a) it is probable that any future economic benefit associated with the item will flow to or from the enterprise; and
- (b) the item has a cost or value that can be measured with reliability.'

It adds that 'an item that possesses the essential characteristics of an element but fails to meet the criteria for recognition may nonetheless warrant disclosure in the notes, explanatory material or in supplementary schedules.'

The IASB's Framework states that for the information in financial statements to be useful to users it must be, among other things, relevant and reliable. It defines an asset as 'a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise'.

The ASB's Statement sets out nine principles on the qualitative characteristics of financial information. The first of these states: 'information provided by financial statements needs to be relevant and reliable and, if a choice exists between relevant and reliable approaches, the approach chosen needs to be the one that results in the relevance of the information provided being maximised.' On this, the ASB's framework differs from the other two, neither of which suggests that relevance should take priority over reliability.

Figure 9: The Qualitative Characteristics of Financial Information



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The ASB Statement defines assets as 'rights or other access to future economic benefits controlled by an entity as a result of past transactions or events.' While the wording of this is materially different from FASB's (assets are identified as present access to future benefits rather than as the benefits themselves), the two alternative wordings might well produce identical results in practice. The ASB definition is closer to the IASB's.

It is not clear in the ASB definition itself whether the word 'controlled' refers back to access, benefits or both, but it is made clear later that it refers to access. However, the discussion of control also includes the following: 'it is generally not possible for an entity to choose if and when to realise the economic benefits derivable from factors such as its market share, superior management or good labour relations because the rights or other access to such benefits cannot be controlled independently of the business as a whole. The entity therefore does not have the control of these benefits envisaged by the Statement, which means that such factors are not assets of the entity.' This last sentence seems to imply that control of the benefits is also required. And by interpreting control in a particular way, the passage as a whole introduces an important restriction on the meaning of assets not necessarily contained in their definition. This is discussed further below. Neither FASB's nor the IASB's framework includes the kind of discussion that appears in the ASB's, apparently ruling out from recognition assets such as good labour relations etc.

According to the ASB Statement, a new asset will be recognised if:

- a) 'sufficient evidence exists that the asset ... has been created ...; and
- b) 'the new asset ... can be measured at a monetary amount with sufficient reliability.'

This again imposes new restrictions, though by creating categories of unrecognised assets, rather than by narrowing the meaning of 'assets'.

Discussion

There are important differences between the approach to reporting embodied in the three frameworks and those reflected in the various proposals examined in this report. The authors of new reporting models tend to ask in an open-ended way what business stakeholders want in the way of information and then recommend that businesses should provide it, while the frameworks adopt a more constrained approach. Specifically, they largely exclude:

- non-financial information;
- forward-looking information;
- the needs of other users except where they coincide with investors'.

It would perhaps be unfair to regard the first exclusion as a defect of the conceptual frameworks. They are, after all, conceptual frameworks for financial reporting. However, the point remains that the reformers who propose new reporting models take a broader view of business reporting in this respect.

The second of these exclusions also imposes an indirect approach. The frameworks state, for example, that investors want information that is useful in evaluating the entity's ability to generate cash. The most direct way of providing this information would be to show it in a statement of future cash flows. Instead, accounts present the user with a series of oblique clues to future cash flows by giving a selection of numbers, chosen on other criteria, based in varying degrees on the business's assumptions about what these undisclosed cash flows will be. The direct approach is ruled out by the exclusion of forward-looking information.

Several of the new reporting models recommend the dissemination of information about a business by, for example, online questions and answers. While the same information might well be given to any visitor to the website, this is essentially a form of private report. Other forms of private reporting exist for example for those institutional investors who have direct access to a company's management. This is not to suggest that financial reporting information is disclosed in a privileged way at such meetings or that it would be to visitors to a website. But the private approach to information about a business is at odds with the public forms of communication assumed in the conceptual frameworks. Some would argue, therefore, that the conceptual frameworks need to be reassessed to take account of the increased possibilities for direct communication with all stakeholders created by information technology.

The frameworks' treatment of assets also diverges from that of the new reporting models. The latter tend to say that any resource of a business is an asset and should be recognised as such. The frameworks' definitions of 'assets' are in fact broad enough to be compatible with this line of thought. But the frameworks then go on to introduce a series of restrictions to narrow down the definition and to restrict further which assets are recognised in the accounts. Each step in this narrowing process is debatable, although an asset that is impossible to measure (if such assets exist) could hardly appear in the balance sheet.

Separability from the business as a whole

As noted above, the ASB's Statement argues that 'it is generally not possible for an entity to choose if and when to realise the economic benefits derivable from factors such as its market share, superior management or good labour relations because the rights or other access to such benefits cannot be controlled independently of the business as a whole. The entity therefore does not have the control of these benefits envisaged by the Statement, which means that such factors are not assets of the entity.' The problem here is the meaning of 'independently of the business as a whole'.

It is common in business for the benefits derivable from particular factors to be realised through their joint operation. For example, the plant that produces a company's products does not generate economic benefits that can be controlled independently of other factors. They depend on the use of numerous other factors that play a part in the business – such as the effectiveness of its buying department, its sales team, its delivery facilities, its general management, and all the further assets that these factors in turn rely on. But it is unclear whether all these other factors add up to 'the business as a whole'.

It is difficult to see what factors in a business would *not* contribute to the realisation of the benefits derivable from the use of its plant (unless they related to a different segment of the business). However, while views on this point will no doubt differ, it is at least an issue for debate whether the ASB Statement singles out in an arbitrary way certain conventionally unrecognised assets as being outside the definition of 'assets'.

Reliability of measurement

The frameworks also create categories of assets that exist but are not recognised in the accounts. The reasons for this vary from framework to framework, but a common reason for non-recognition is that the asset cannot be measured at a monetary amount with sufficient reliability. This filtering mechanism, excluding what cannot be measured with sufficient reliability, is part of the ASB's framework. It could be argued that this exclusion (or filtering) contravenes the Statement's principle that 'if a choice exists between relevant and reliable approaches, the approach chosen needs to be the one that results in the relevance of the information provided being maximised'.

If an asset exists and can be measured at all, one could argue that relevance is maximised by recognising its existence, rather than not doing so. Neither FASB's nor the IASB's framework gives priority to relevance over reliability, so there is not the same problem of internal consistency here that arises with the ASB Statement. However, one may still question whether the various exclusions built into the recognition criteria will result in disclosure of the most useful information or in something less.

Conclusions

Overall, the gaps between the frameworks and the new reporting models suggest a need for further work in four directions:

1. the development of a broader framework for business reporting (as proposed by the Jenkins Report);
2. an examination of whether the indirect approach to meeting users' information needs about the future is the most useful one;
3. consideration of whether increased opportunities for direct communication with stakeholders require any modification of the frameworks; and
4. an examination of whether the frameworks' treatment of assets is the most useful one.

The first of these recommendations for further work is reflected in Questions (3) and (9) in Chapter 3, the second in Question (24), the third in Question (10), and the fourth also in Question (3). Question (11) – on the presentation of information in a meaningful hierarchy – is also relevant to any work that might be undertaken to review the conceptual frameworks. In Chapter 2, the adequacy of the existing frameworks is identified as one of the six key issues in the debate on new reporting models.

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Naturally, none of the commentators should be assumed to agree with the views expressed in this report and they are not responsible for any errors or omissions.

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