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True and Fair View?

The Glaring Deficiencies of Financial Reporting

'There must be a moral hidden somewhere in the observation that the Lord's Prayer consists of 56 words; The Ten Commandments, 297 words; the American Declaration of Independence, 300 words. And a rough estimate puts the guidance on IFRS at about 1.4 million words!' Kieran Poynter, UK chairman of PricewaterhouseCoopers, certainly made his point, though the comparison limps a bit. International Financial Reporting Standards (IFRS, formerly IAS), like the US Generally Accepted Accounting Practices (GAAP), are not stirring moral commandments. They are required to regulate the accountability of companies of various sizes and in different sectors. Indeed, accounting standards reflect the complexity of today's business world.

This said, there is little doubt that financial reporting is rich in detail and poor on clarity. Above all, it seems geared to outmoded priorities and procedures. The accounting profession in the USA has indeed produced the staggering quantity of around 5000 pages of accounting rules. However, as KPMG partner Bob Elliott points out: 'At best, today's financial statements are an obsolete product.' In actual fact, the accounts published focus on the assets of the industrial age: inventory, machinery, buildings, etc.

'Accountants are blind to the assets that really matter', contends Simon Caulkin in *The Observer*. There have in fact been vociferous protests that the accounting profession has continued to ignore nonfinancials and play down their importance. Their logic is indeed: if you can't count it, it doesn't count.

The question remains: Who can explain why Microsoft's market cap far exceeds book value and has at times been larger than that of the US Big Three auto manufacturers added together? The company's fixed assets are insignificant. But the Microsoft brand is trusted and feared across the world, its intellectual capital is immense and its business strategies are highly effective. And, last but not least, the Gates foundation spends more money than any other foundation on good causes.

Those reading the company's annual reports are none the wiser as to its fortes. Microsoft presents a series of catchwords on integrated innovation, responsiveness to customers and intellectual property without specifying or indeed quantifying major assets. The world's leading software producer's 10-K Note on Intangible Assets is a typically formal statement primarily addressing acquisitions. On the other hand, its Global Corporate Citizenship Report is a lot more specific, concentrating on issues like Internet safety and digital inclusion that are close to its core business.

Microsoft is no exception. Most companies fail to address the 'N' question. SAP, a world leader in business process software, has a more systematic approach to reporting nonfinancials than Microsoft. And indeed, it provides relatively good insights into its innovation track record and customer service, while however failing to focus on the business environment or its intellectual capital. On the other hand, the German software producer has published various Innovation and Employee reports, giving an excellent overview of know-how exchange, personnel development, etc. But the fact remains that the reporting of two of the world's best IT companies hasn't kept pace with performance; both Microsoft and SAP fail to communicate their true value.

THE OLD ECONOMY'S REPORTING PARADIGM

The accounting profession is well aware of these deficiencies. The Institute of Chartered Accountants in England & Wales published a study entitled *New Reporting Models for Business*, in which it pinpointed five limitations of traditional financial reporting:

- It fails to address a broad range of users' needs.
- In reporting historical performance, financial statements 'focus on lagging indicators and not leading nonfinancial indicators of future financial success'.
- Its criteria for recognition of assets preclude the identification of relationship and knowledge assets on which modern business depends.
- Contemporary reporting encourages readers to focus on summary earnings and to take a short-term approach.

- The information provided results in a huge gap between the information level of managers on the one hand and of investors and other stakeholders on the other.

Thus, internal and external perceptions of corporate value tend to vary considerably. Basically, reporting adheres to an Old Economy paradigm that is fixated on tangible assets. A number of initiatives on both sides of the Atlantic have focused on improving the standards of business reporting, as opposed to conventional financial reporting. The US Financial Accounting Standards Board (FASB) has published several reports on the subject, but in practical terms, little has changed. Robert A. Howell, an authority on finance and accounting, pointed out in *FORTUNE* magazine that ‘the big three statements – income statement, balance sheet and statement of cash flow – are about as useful as an 80-year-old Los Angeles road map’.

Accounting procedures tend to be not only formalistic but arbitrary, regardless of where they come from. A case in point is the measurement and treatment of intangible assets. For instance, IAS 38 includes within its purview acquired assets like copyright, customer lists and relationships, but excludes internally generated goodwill, brands, human resources, etc. The accounting dilemma is clear: IAS 38 addresses the issue of impairment, which can consist of a fixed amortisation or be subject to an impairment test on a yearly basis, depending on whether an asset has a restricted or indefinite life. The real issue is, however, how to determine the value of an intangible asset in the first place. Here, there is a dearth of viable solutions.

This has led to concrete calls for a remodelling of accounting standards and procedures. As far back as 1995, management gurus Michael Porter and Robert Denham called on the Security and Exchange Commission (SEC) and FASB to develop a kind of GAAP for nonfinancials like customer satisfaction, process quality and workforce training. Two years before this, Peter F. Drucker had warned that conventional accounts were like an X-ray of the enterprise’s skeleton, thus not identifying a variety of diseases like cancer and Parkinson’s that could be fatal for a company’s health. In 2001, Thomas A. Stewart criticised in *FORTUNE* a plethora of meaningless statistics, highlighting the irrelevance of many traditional accounting measures. Practitioners agree: Walt Wriston, the veteran CEO of CitiCorp, approved of the fact that some banks were taking nonfinancials like trade names and patents as collateral.

One management approach that clearly merges financials and nonfinancials is the Balanced Scorecard, developed by Robert Kaplan and David Norton. Expressly designed to balance, not eliminate, the financial perspective, the Scorecard includes three further perspectives: customers, business processes and ‘learning and growth’. It thus gives companies a larger management dashboard by guiding them to develop new metrics. But while the Scorecard has helped several companies – Sears Roebuck is perhaps the best-known case – to improve their operating results, it has not led to a sea of change in financial reporting.

The same applies to more recent attempts to balance corporate priorities. In ‘The blended value proposition: Integrating social and financial returns’, published in *California Management Review*, Jed Emerson tries to develop integrated metrics for a company’s economic, social and environmental performance. However, there is little guidance as to how nonfinancials can coherently coexist together with their dominant financial cousins in the context of concrete reporting.

CHANGE REPORTING, NOT ACCOUNTING

Why has financial reporting proved so resistant to change, despite many calls from influential quarters? The answer could well be: because of the way it has developed. In his treatise *Modern Capitalism*, the German economist Werner Sombart asserted that capitalism was inextricably interconnected with double-entry book-keeping. This kind of accounting dates back to the year 1494, when a Franciscan monk, Luca Pacioli, published his treatise on double-entry, based on early practice in the Italian city-states. Ever since, reporting has evolved around debit and credit, assets and liabilities. Pacioli’s system conquered the world, being described by Goethe as ‘one of the most beautiful discoveries of the human spirit’.

Despite such enthusiasm, it wasn’t till the 19th century that book-keeping developed in England, though Josiah Wedgwood used basic cost accounting, including calculating overhead costs, to keep his pottery factory in business in the late 18th century. Capital markets developed and the accounting profession came into being, first in Great Britain, then in the United States and other industrialised countries. One basic truth has remained: accounting is reactive, rather than proactive. It took the corporate failures of the Great Depression in 1929 for the American accounting profession to develop its own Generally

Accepted Accounting Practices. In 1934, the SEC was founded to control the 'full and fair' disclosure of financial information.

At approximately the same time, Alfred Sloan designed accounting reports at General Motors, while Donaldson Brown developed key ratios like Return on Investment at DuPont. Slowly, the internal world of management accounting and the external world of annual reports merged. The Financial Accounting Standards Board (FASB) was founded in 1973; similar boards developed in other countries. The investing community began getting hitherto confidential data. Key ratios and performance indicators burgeoned, with companies vying with each other to present fancy charts and flashy presentations. This was the Anglo-American model, emulated if not copied in other parts of the world. The traditional emphasis in Continental Europe has been on providing accounts for creditors, not for investors. This led to a defensive approach – to legalism rather than liberalism – but IFRS is expected to put an end to this kind of accounting particularism.

Irrespective of cultural proclivities – for instance, French banks have strongly attacked the IFRS process, which is seen to be overly Anglo-Saxon – accounting is too embedded in traditional priorities to be able to radically change. Most reports, whether annual or quarterly, consist of an array of tables and notes, embellished by mundane commentary that rarely provides insights into the figures. Management Discussions & Analyses (MD&As) or Operating and Financial Reviews (OFRs) seldom give investors a coherent interpretation of the previous year, let alone a clear outlook to the coming year. Investor Relations presentations, often published on websites, put the company's equity story across a lot more eloquently than conventional reporting does. However, they tend to be equally deficient on nonfinancials.

Meanwhile, pressure is mounting on companies to be more explicit about their assets and potentials. In a worldwide survey of senior managers, fittingly entitled *In the Dark*, Deloitte discovered that 92% of the 250 executives interrogated by them believe that financial indicators do not capture their own companies' strengths and weaknesses. The majority complained that they lacked key information on nonfinancial drivers of success, which made it difficult for them to take mid- and long-term decisions. Intriguingly, 73% disclosed that they are under increasing pressure to measure nonfinancial factors.

These findings are confirmed by the results of surveys covering other stakeholder groups: the consulting company Broadgate polled US portfolio managers, 90% of whom expressed dissatisfaction with financial reporting as a basis for their investment decisions. Indeed, the current standard of reporting makes it difficult for companies to expect an appropriate valuation in the capital markets.

A PricewaterhouseCoopers survey in Singapore revealed that 71% of corporate respondents considered their share prices to be undervalued. In a knowledge-based economy like Singapore, such nonfinancials as intellectual capital, brand value and customer satisfaction are particularly important. PwC discovered a reporting gap between the information that chief executives perceived to be important and what got reported; this confirms the evidence provided by the Deloitte study.

Dissatisfaction with the current state of financial reporting is also expressed by investors (Table 1.1). Anita Skipper, Head of Corporate Governance at Morley Fund Management, has been quoted as saying:

> A traditional financial report doesn't necessarily tell you about a company's culture, its research and development, its brands, how it treats its employees and its customers. We want to know as much as possible about these issues because they can be just as important to the future health of a company.

Table 1.1 The reporting gap

Financial reporting	Nonfinancial reporting
• More than 500 years old	• 10–20 years old
• Highly formalised, strong standard-setters (GAAP, IFRS)	• Completely uncharted, no statutory requirements (GRI as voluntary code)
• Addresses investors	• Addresses stakeholders (including investors)
• Fixed reporting intervals (yearly, quarterly)	• Discretionary reporting (yearly/bi-yearly, etc.)

GETTING FORM TO FOLLOW FUNCTION

Despite this pressure, it would be naïve to assume that accounting procedures are going to change radically. Accounting needs continuity, and financial reports have to be comparable over long periods of time. The American economist and presidential adviser John Rutledge has pointed out: 'Monkeying with financial statements, for almost any reason, is a terrible idea.'

This is undeniably true in accounting terms. However, accounting is by no means as objective as it often appears. The classic case of how accounting standards can distort results was the financial year 1993 of Daimler-Benz (later DaimlerChrysler). The company recorded a net profit of $733 million under German accounting standards (HGB, the German Commercial Code), while under USGAAP, it made a loss of $589 million, thus creating a staggering discrepancy of $1.3 billion. The real point, however, is that it was difficult for outsiders to judge whether the company was doing rather well or terribly badly. Thus, the function of accounting, being to provide a true and fair view of the company's performance, was grossly perverted by the form, in this case the diametrically different accounting standards.

The corollary of this simple verity is: Trying to introduce nonfinancials into financial statements is difficult at best, and trying to value nonfinancial assets is like squaring a circle. A prime example is Skandia. It pioneered the concept of Intellectual Capital (IC) in the mid-1990s, publishing a series of supplements to its annual reports. This was an intellectually stimulating attempt to pin down intangible assets like human capital, structural capital and customer capital. However, Skandia faced the same problem that confronted the Balanced Scorecard: it was trying to harmonise indicators that don't fit together.

Beyond this, Skandia's scope was too narrow: it considered intellectual capital to account for the entire difference between book value and market cap, whereas the kinds of know-how, skills and potentials covered by IC only account for a part of the gap. This became clear when the Swedish insurance company experienced a major scandal concerning excessive bonuses and management perks in the early 21st century which led to a spectacular exit of top management. While its 2003 Annual Report conceded that Skandia's reputation and brand had suffered in the short term, the company was understandably unable to quantify or even estimate in qualitative terms this loss, although it was obviously detrimental to market cap. After the scandal, governance became far more relevant than intellectual capital – an issue on which the company had in any case stopped reporting.

There is in fact a primary difference between a company's accounts and its reports. Even in the ethical community, financial accounting is considered reasonably sound. John Elkington, founder of the consultancy SustainAbility, coined the term 'Triple Bottom Line', which postulates that companies need to have not just a financial but also an environmental and social balance sheet. He has estimated that, in general, financial accounting would score 8 out of 10 points, as against 3–4 out of 10 for environmental accounting and 1–2 out of 10 for social accounting.

Elkington's world view is predominantly focused on ethical value; however, the same problems are experienced in trying to extract precise numbers and reliable ratios from brands, customer relationships, human resources and other nonfinancials. Human resources, for instance, are only recorded as a cost. According to a Concept Statement published by FASB, a cost is an economic sacrifice. So the most important resource most companies own is really a sacrifice! This reminds the author of how Arnold Schwarzenegger, the film star and California governor, responded when asked who his famous writers were. 'My favourite fiction writers', he said, 'are studio accountants.' The point being of course that the most vital nonfinancial asset a film studio owns are its actors and directors, none of whom plays any role in the balance sheet.

For historic and structural reasons, accounting is massively overclassified; function literally follows form. Reporting on nonfinancial issues on the other hand is not only not classified, it's completely uncharted.

NONFINANCIALS: THE OVERHEADS OF THE 21ST CENTURY

Financial reporting generally presents a wealth of detail, while lacking coherence. Companies that focus on compliance may manage to produce reports that save them from prosecution. However, in terms of transparency and communicative quality, a compliance fixation can lead to substandard reporting.

According to Mike Guillaume, one of the world's leading experts on reporting and founder of a major international reporting ranking, Enronitis has played a major role in leading companies to adopt a 'compliance first' attitude. In the wake of the scandals surrounding Enron, Worldcom, Tyco and several other companies, accounting became an exercise in caution rather than transparency. As the results of the *Annual Report on Annual Reports* – a yearly ranking of best reporting practice across the world – show, American reports have clearly lost the edge they had in the 1980s and 1990s. In the 2000 ranking, 13 US companies were among the Top Twenty; five years later, not a single corporation from the United States reached the top bracket (Table 1.2).

Table 1.2 World ranking shows decline of American reporting*

2000: Top Twenty		2005: Top Twenty	
1. Ford Motor	USA	1. CIBC	Canada
2. Alcoa	USA	2. TELUS	Canada
3. McDonald's	USA	3. SCA	Sweden
4. SAS	Sweden	4. Trelleborg	Sweden
5. United Technologies	USA	5. WPP	UK
6. Bank of Montreal	Canada	6. James Hardie	Australia
7. Sara Lee	USA	7. Adidas-Salomon	Germany
8. Anheuser-Busch	USA	8. Danone	France
9. Volvo	Sweden	9. TNT	Netherlands
10. Merck	USA	10. CLP	Hong Kong
11. Eli Lilly	USA	11. Stora Enso	Finland
12. Knight-Ridder	USA	12. Philips	Netherlands
13. IBM	USA	13. Woolworth	Australia
14. Coca-Cola	USA	14. Electrolux	Sweden
15. Danone	France	15. Sasol	South Africa
16. Royal Bank of Canada	Canada	16. Novartis	Switzerland
17. Quaker Oats	USA	17. SAS	Sweden
18. Johnson & Johnson	USA	18. Wienerberger	Austria
19. Ahold	Netherlands	19. Securitas	Sweden
20. Electrolux	Sweden	20. BMO Financial	Canada

* Results of the *Annual Report on Annual Reports*, run by enterprise.com in Vilvoorde, Belgium, since 1996.

'Some reports seem to be written for regulatory bodies instead of being aimed at investors and other stakeholders', according to Guillaume. The MD&A sections in American reports are correspondingly weak, while the standard of European reporting is steadily rising, both in financial and nonfinancial terms. Canadian companies, in particular banks like CIBC and BMO, have made enormous progress in uniting the two worlds; CIBC's Annual Accountability Report for instance immaculately presents key figures and a detailed breakdown of the year's results, a detailed outlook with priorities for the coming year as also valuable information and commentary on clients, employees, governance and CSR.

Nonfinancials are the overheads of the 21st century. The major challenge facing corporate management is how to grasp their importance, define their parameters and report on them on an ongoing basis. The accounting concept of a going concern has so far been defined in defensive form. According to IFRS, it applies to companies that have neither the intention nor the need to liquidate or cease operations within 12 months of the balance sheet date. Auditors are, however, supposed to consider both financial indicators and nonfinancials, like loss of key management or of market segment, when considering whether the company audited is a going concern. Reporting on financials and nonfinancials needs to present the case for a company as a going concern in broader terms – in other words, present the case for its reputation on financial markets and with stakeholders. None of this can happen from one day to the other. Chris Fay, the former Chairman of Shell UK, was right in commenting: ‘We are clearly at the start of a long and difficult journey towards a new type of business reporting . . . ’

The question is: How can today’s value drivers be reflected in corporate reporting? As in accounting, reporting nonfinancials only makes sense if a long-term view is taken. No one would dream of disclosing ROI or EVA once only, and never again. Similarly, brand value, employee loyalty, customer satisfaction, social rating and many other indicators only make sense if they are consistently measured and reported. Keynes might have been right in pointing out that, in the long run, we are all dead, but in the meanwhile, consistency counts.

Box 1.1 Boise International: Fictive Case Study (1)

On a cold afternoon in April 2007, Brian O’Neill sat morosely at his desk on the top floor of the Boise skyscraper in Brussels. Actually, he had nothing to complain about. Boise International, a multinational conglomerate based in Belgium with branch offices in 25 countries across the world, had just published its annual accounts for the year 2006 and shown substantial growth during the previous year. Turnover was up by 15% and net revenues had increased by a respectable 9%. As CEO of Boise, O’Neill could be proud of himself. Except for the fact that a sizeable chunk of his and his fellow directors’ salaries were pegged to Boise’s stock performance – and the company’s share price and market cap had remained stagnant for the last three years.

O’Neill, born in Ireland and educated at Harrow and Cambridge, kept leafing through his company’s annual report, searching for reasons why financial markets priced Boise at a mere €20 billion, far below benchmarks like General Electric or even Siemens. There were good results from all three divisions: consumer finance had grown revenues by a stunning 18%, medical products was up by 7% and even energy, a notoriously sluggish business area, had registered a 3% rise in income. So why hadn’t the world noticed? O’Neill summoned his CFO, Giovanni Gabrielli and the new Head of IR, a young American called Harry Gremling, for a quick meeting and confronted them with the evidence.

Gabrielli immediately pulled a long face. He had spent literally every weekend last autumn working to cope with new IFRS stipulations. Boise had successfully dealt with all compliance issues; that in itself was a great achievement, wasn't it? Financial markets were notoriously volatile, he implied, and share pricing was not something that serious managers should bother with. O'Neill shook his head in exasperation, trying not to fuel his own prejudices about Italians and outdated accounting procedures, and looked at Gremling, who shrugged his shoulders and pointed out: 'I can tell you why. We simply don't have a proper equity story. Analysts inevitably do a sum-of-the-parts calculation and then make a conglomerate discount. At the last analysts meeting, one of them told me they don't know what kind of value drivers we have or even what our strategy amounts to.'

O'Neill got even more worked up: 'What about our marketing research in consumer finance? GE can't match that. And I thought everyone knows that our solar technology is world class. Beyond which, we got a prize for our corporate volunteering projects from the EU. But of course, nothing of that kind ever gets into our annual report.' Gabrielli mumbled that reports were legal documents with no space for loose narrative. Gremling quashed that however by lauding the strategic focus of GE's statements to stakeholders in its annual reports, while praising Siemens for highlighting success factors in its segment reporting.

'I want action', said O'Neill. 'More visibility and reputation. By this time next year, I want to be invited to speak on corporate transformation at the World Economic Forum in Davos, I want *Harvard Business Review* to be covering us as best practice.' Gabrielli stared at the floor, Gremling nodded and shrugged his shoulders. O'Neill convened a top management meeting for the next month.

Boise: Corporate Snapshot

Founded:	1897
Headquarters:	Brussels
Divisions:	Consumer finance Medical products Energy and power supply
Sales*	€28 billion
Net income*	€850 million
Employees*	180 000

* Figures from Annual Report 2006.