Reporting Nonfinancials

Kaevan Gazdar

John Wiley & Sons, Ltd

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Foreword

Reporting on non-financial aspects of business performance has become of increasing importance in two respects. First, companies are often significant actors within society. If they are to thrive and to enjoy the trust and cooperation of those around them, they need to be prepared to be transparent and accountable to a range of stakeholders – including governments, employees, customers, communities and NGOs. Second, from a traditional investor perspective, it is quite clear that reporting solely on financial performance provides a seriously incomplete picture of a company's prospects, especially as intangibles now make up a higher proportion of corporate value than ever before.

In regard to meeting the information needs of a range of stakeholders, significant progress has been made through the Global Reporting Initiative as well as through the experiences and innovations of a number of companies in the development of their annual social and environmental reports. From these sources it is now much clearer what the ground rules should be for judging what is material about a company's non-financial performance and what significant stakeholders expect to see reported. There are also a number of significant initiatives, involving GRI sector supplements and frameworks agreed by industry associations – such as has been done by the International Council on Mining and Metals – to aid comparison between companies operating in the same sector.

But the principal focus of Kaevan Gazdar's thorough and insightful book is how to ensure that reporting on non-financial performance can be made more rigorous, more quantitative and more clearly relevant to the management of core business challenges. It is certainly a frustration that within the financial community the progress made to date in

integrating the work of mainstream financial analysts and their 'socially responsible investment' colleagues has been disappointingly slow. It is sometimes marked by a seeming lack of mutual respect of the insights each brings to the process.

There is a plethora of national-level initiatives around reporting requirements. The debate has been evolving at different speeds in different geographies and sectors. In Europe, for example, there is perhaps more intensive interest in environmental and social performance than in the United States. But within Europe there are differences with France and Germany putting much of their focus on employee-related 'social' issues and reports by many companies in the United Kingdom placing emphasis upon wider issues of business impacts on society at large. In Brazil, India or South Africa issues associated with poverty, development and HIV/AIDS normally loom large.

In summary, non-financial reporting should aim to complement the story told by the short-term financials by enabling investors and other stakeholders to understand the underlying drivers of value. These drivers include strategy, reputation, governance, intellectual property, human resources, management of key impacts and stakeholder perceptions. It is taking longer to get to a consensus about how this is best to be done than I had hoped, but as practices evolve I am confident that what will emerge is a more rounded and forward-looking account of a company's 'health' for investors and other stakeholders alike. Kaevan Gazdar's book deserves attention and through its analysis helps to move the debate forward.

Sir Mark Moody-Stuart
Chairman of Anglo American plc, Chairman of the United Nations Global Compact Foundation

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This book developed over a period of years in the context of a number of speeches and seminars, held in various European countries, and of different publications that came out during the same period. Klaus Rainer Kirchhoff, who runs Germany's leading financial reporting agency, and with whom I have co-authored several books, has always been a stimulating sparring partner in the quest for new ideas and pragmatic solutions. André Habisch, founding director of the Center for Corporate Citizenship in Germany, has an unusually broad view of corporate responsibility, which he was kind enough to share with me. Mike Guillaume of e.com in Brussels is the ideal person to discuss approaches and strategies to reporting; he has invariably been very generous in finding time to discuss relevant issues. David M. Phillips of PricewaterhouseCoopers in England has over the years exchanged ideas and been a mine of information on best reporting practice. Mark Goyder, Founder and Director of Tomorrow's Company in London, was a prime source of unorthodox perspectives.

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Introduction
Goodwill and Blue Skies?
Getting a Grip on Nonfinancials

'Once considered the Cinderella of corporate disclosure, nonfinancial reporting . . . is quickly taking its place alongside financial reporting as indispensable to assessing company value and future prospects.' Sir Mark Moody-Stuart, successively Chairman of the Boards of Shell and Anglo American, is one of an increasing number of prominent leaders calling for a broader perspective on measuring and reporting value. A number of influential personalities agree with Moody-Stuart. Mervyn King, for instance, who chaired various Corporate Governance commissions in South Africa, has highlighted the 'nonfinancial aspects of governance.' And as far back as 1991, Robert G. Eccles, then a professor at the Harvard Business School, wrote 'The performance measurement manifest'. In this path-breaking article, published in *Harvard Business Review*, Eccles called for a shift from purely financial figures to an emphasis on quality, market share and other nonfinancial measures.

The question being: Is there a consensus on what nonfinancials are, so that entrepreneurs and managers can focus on them? The quick answer is: No. Classifications vary, depending on the credentials and interests of those propagating the issue. Sir Mark Moody-Stuart, for instance, has a strong sustainability bias, citing carbon emissions, labour standards and corruption policies, but also quality of governance. Mervyn King, when asked outright what he meant by the word, mentioned innovation, technology and human resources. And Robert Eccles has a clear business management perspective; for him, market share, quality, innovation and customer satisfaction are of central importance.

Those seeking clarity on the nature of nonfinancials should be prepared to find a vacuum. Search engines like Google show thousands of hits; and financial media like the *Financial Times* and *The Economist* write widely on the subject. Definitions, however, are practically nonexistent. In fact, nonfinancials are rather like the minotaur, a monster with the body of a man and the head of a bull, who was kept by King Minos in a labyrinth until Theseus put a sword through him.

The accounting profession tends to define nonfinancial assets as being physical assets like real estate and machinery. This is far removed from the general perceptions that tag the word onto anything from brands and customers to reputation and social responsibility.

However, nonfinancials have a potent synonym: intangibles. Here a plethora of definitions exists:

- OECD calls them 'non-material factors that contribute to the growth and performance of firms and nations without being included in the traditional category of fixed assets'.
- Baruch Lev, Professor at the Stern School of Business in New York and a world authority on the subject, uses the words intangibles, knowledge assets and intellectual capital interchangeably.
- A UK Government White Paper refers to a company's intangible assets as consisting of the skills and knowledge of its employees, its business relationships and its reputation.
- IAS 38, the International Accounting Standards treatment of intangible assets, considers them to be non-monetary and without physical substance. Examples are computer software, patents and copyright.

CLOSING THE GAP BETWEEN BOOK VALUE AND MARKET CAP

This author's favourite definition comes from an American M&A consultant, who proclaims: 'Both goodwill and blue sky are intangible assets.' That, of course, is not exactly a meaningful approach to the subject. In general, intangibles apply more strongly than nonfinancials to assets that cannot be physically touched and that are hence not tangible. Nonfinancials, on the other hand, often serve as a synonym for Sustainability or Corporate Social Responsibility, as was the case in the 2004 ranking *Risk & Opportunity: Best Practice in Non-Financial Reporting*. This ranking was carried out by the British consultancy SustainAbility in cooperation with UNEP and Standard & Poor's; the criteria have a strong sustainability slant and, indeed, former versions of the ranking used the term 'Sustainability Reporting'.

There is in fact a prime need for a coherent definition and classification. According to this author, nonfinancials are *resources of significant value, that are rarely quantifiable but that both account for the gap between book value and market capitalisation as also contribute greatly to corporate reputation.*

Let's look at the individual terms used in this definition:

- *Significant value*: Leonard Nakamura of the Federal Reserve Bank of Philadelphia estimated that US investments in brands, human resources, Research & Development, etc., totalled around $1 trillion in 2000 and matched the private sector's investment in physical assets like property and equipment.
- *Rarely quantifiable*: What monetary value can a company legitimately put on its human resources or its reputation?
- *The gap*: In 2004, the pharmaceutical corporation Pfizer had a market cap that reached $270 billion. Its book value barely reached $20 billion. The rest consisted of the market's consideration of assets like patents, know-how and management skills.
- *Corporate reputation*: Shell's tribulations with Brent Spar and its involvements in Nigeria in the 1990s led to media flak and consumer boycotts, costing it a fortune in terms of both reputation and revenues.

The ratio between book value and market cap is highly volatile. In 1999, during the heyday of the New Economy, it averaged 1 : 12 for a group of high-growth companies. Companies in sectors with strong knowledge assets far exceeded these ratios: Microsoft's market cap has been more than 25 times as high as its book value. The same applies to companies with valuable brands. Coca-Cola is a case in point. Even conglomerates profit from the brand value attached to their constituent parts: GUS, the British holding company with a significant share in Burberry and the Argos Retail Group, reached a market capitalisation of £7.5 billion in 2004, with net book value barely reaching £1 billion.

Nonfinancials are a vital factor in Mergers and Acquisitions. Goodwill, which includes reputation, brands and perceived strategic advantage, accounts for a large percentage of the purchase price. In many cases, goodwill far exceeds net tangible assets. A classic case was the acquisition of Rowntree by Nestlé in 1988. The Swiss multinational paid £2.5 billion for the British chocolate-maker, whose physical assets were estimated at only £0.5 billion. On the other hand, when Britain's leading bank HSBC took over the US financial institute Household in 2003, the deal was moderately priced at 1.7 times the book value.

Nonfinancial reporting can play a major role in presenting a company's intangible assets and thus contribute to raising the purchase price, just as it can support high market cap. These belong to its most

important functions. The results of a survey carried out by the opinion research institute MORI (Table 0.1) highlight other benefits like enhancement of a company's reputation and increasing stakeholder awareness.

Table 0.1 Nonfinancial value drivers

Top twelve measures*	
1. Leadership	7. Technology and processes
2. Execution of corporate strategy	8. Human capital
3. Communication and transparency	9. Workplace organisation and culture
4. Brand equity	10. Innovation
5. Reputation	11. Intellectual capital
6. Alliances and networks	12. Adaptability
Top four benefits†	
1. Enhances a company's reputation	3. Is important for business management decisions
2. Stakeholders are increasingly interested	4. Makes it easier for investors to understand how well the company is performing

* Ernst & Young research.
† Survey of companies in Britain carried out by MORI.

The key question is: What should a company be reporting about? Obviously about those nonfinancials that create the most value. Jon Low, co-author of the book *Invisible Advantage*, poses the question: 'Do you know how much of your company's value is based on items that don't appear on the balance sheet?' Indeed, very few companies have a coherent answer to this question, although research carried out by the Cap Gemini Ernst & Young Center for Business Innovation indicates that around 35% of the decisions made by portfolio managers are determined by nonfinancial issues.

Inability to get a grip on nonfinancials is a prime management deficiency. David Larcker, Professor of Accounting at the Wharton School, has warned that companies are failing to identify the right nonfinancial value drivers. According to him, 'too much is based on management folklore and intuition. This leads to assumptions that are often half-baked or wrong.' Seconding him in a *Financial Times* article entitled 'Non-financial measures just don't add up', Robert Bruce highlighted the dangers involved in deciding that factors like employee

loyalty and customer satisfaction are the key performance indicators. This is certainly true but, on the other hand, many companies are run on purely financial criteria, thus ignoring the foundations on which financial success are built. Defining and focusing on vital nonfinancial indicators is becoming a key management issue.

Step 1: Classifying Nonfinancials

Value drivers vary (see Figure 0.1), depending on countries, sectors and corporate priorities. That is why this book adopts a broadly-based classification of nonfinancials:

Competitive Value

This category encompasses customers, brands and markets. Competitive value tends to be the major nonfinancial for consumer goods manufacturers like Coca-Cola and retailers like Wal-Mart, but also plays an increasing role in the financial services sector. Brand value, customer base, market share: these and other variables influence the perceptions of investors, analysts and fund managers.

Management Value

A company's strategy, its mechanisms and processes of corporate governance and also its ability to forecast future performance are important value constituents. Management skills are a vital asset for all business organisations, being particularly important for conglomerates like General Electric and Siemens, which both have complex business models. Governance has become one of the vital issues of the 21st century in the context of such scandals as Enron, Tyco and Vivendi. A host of ratings and rankings measure the governance performance of companies across the world. Future performance is probably the most potent determinant of share price; most companies, however, restrict their reporting to earnings forecasts and warnings, without providing a rationale for their prognoses.

Human Resources Value

The productivity, motivation and potential of the company's workforce are in many cases its most vital asset. Obviously, this particularly applies to software producers like Microsoft and SAP, although it is

equally true of companies in sectors where intellectual capital is not the vital success factor.

Ethical Value

Both in terms of strategies and reporting, this value constituent, which covers Corporate Social Responsibility, Sustainability and Stakeholder Dialogue, has exploded in amplitude since the mid-1990s. A company's ethical value – as perceived by the media, by powerful NGOs like Greenpeace and Ethical Trading Initiative, and by its customers – can make or break its reputation. Shell and Nike are testimony to this premise. Broken reputations can detrimentally affect market cap, although there is no automatic connection between the two.

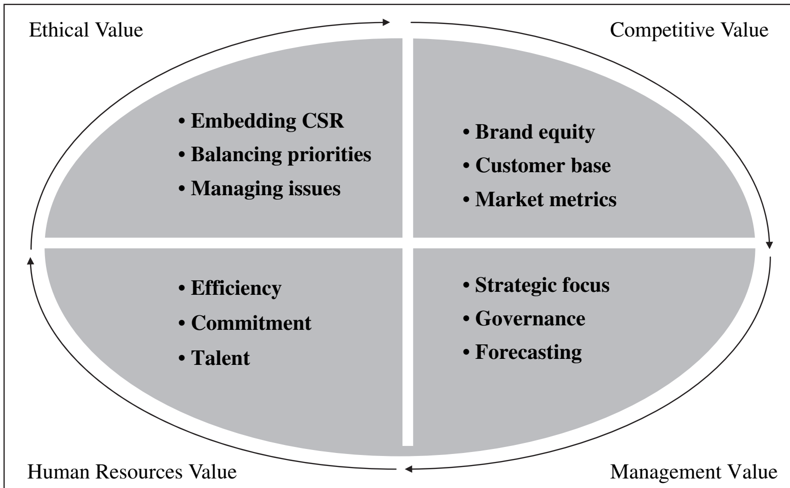

Figure 0.1 Classification of important nonfinancials

Step 2: Adjusting to Regional Priorities

Given this framework, companies need to decide not only on their own priorities but also on normative proclivities in the countries in which they operate. Alison Thomas of Price WaterhouseCoopers highlights regional preferences: according to her research, German stakeholders are attuned to information on quality control whereas the Scandinavians expect environmental benchmarks. This is indeed the case. Countries in Continental Europe, for instance, traditionally provide far

more concrete information on human resources than their counterparts in the Anglo-Saxon countries; this derives from mechanisms like co-determination and strong employee lobbies.

The same applies to ethical value:

- For historic reasons, most US companies see their social responsibility mostly in terms of community work. They in fact seriously underestimate public opinion abroad on ecological or biological issues. Monsanto ignored the reservations about genetically manipulated food in Europe at its peril; ExxonMobil clearly made the same mistake in dismissing the greenhouse effect and neglecting to invest in renewable energies.
- Japanese culture and geography have influenced a special approach to corporate philanthropy and a strong degree of ecological orientation. Thus, the country's sustainability reports have a strong environmental bias.
- A stakeholder survey carried out by the PR companies ECC and Fishburn Hedges showed that while a large majority of British respondents expected CSR reports to include business and operational issues and be useful for investors, their German counterparts did not.

American companies, such as McDonald's, have reacted to this kind of regional diversity by producing their own CSR reports for Europe. In general, while Competitive and Management Value can be generally assumed to adhere to universalistic logic, Human Resources and Ethical Value are strongly determined by the cultural environment. Thus, companies need to identify, measure and report on nonfinancials with a uniform strategy, while modifying priorities on a regional level.

Step 3: From Consciousness to Action

Consciousness of the need to integrate nonfinancials into the managerial and reporting process is growing. The Swiss bank Credit Suisse, for instance, pointed out in its 2001 Annual Report:

> Credit Suisse Group's market value is driven by its financials, and also by intangible values that cannot be captured in figures – such as the strength of its brand, its good reputation, the intellectual capital of its employees and the loyalty of its clients. The market acknowledges these values and prices them into sales forecasts and share valuation, though it does not yet do this on a standardized basis.

A small group of pioneers, including the Danish pharmaceuticals company Novo Nordisk, the British energy provider BP and the Canadian bank CIBC, are well on their way to achieving a dual focus. These companies have a vision that transcends short-term return on equity. Profitability remains a vital issue, balanced however by broader priorities like market position, HR productivity and corporate responsibility.

Leaders in these companies show an awareness of the complex interaction between parameters like governance, reputation, brand value and financial performance; their reporting increasingly reflects this awareness of multiple priorities. Instead of producing and distributing gigantic chunks of unsorted data and self-gratifying commentary – still the general reporting rule – these companies provide coherent disclosure and have the courage to be self-critical. This increases both their accountability record and their credibility.

A rising number of companies have begun to focus on their nonfinancials and have reported on those issues. However, there is a signal lack of knowledge on why they should do so, what they should concentrate on and how they should go about it. These are the issues that this book addresses.

Part I
THE WHY

Though your balance-sheet's a model of what
balance-sheet should be,
Typed and ruled with great precision in a type that all
can see;
Though the grouping of the assets is commendable and
clear,
And the details which are given more than usually appear;
Though investments have been valued at the sale price of
the day,
And the auditor's certificate shows everything O.K.;
One asset is omitted – and its worth I want to know,
The asset is the value of the men who run the show.

From: *Journal of Accountancy*, May 1938

1

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 over-classified; 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).