

## Value Reporting on Micro and Macro Perspective-Way Forward

JAMALUDDIN AHMED\*

*Value Paradox as a problem of capture: Accounting for intangible assets within the firm confronts the Value Paradox in terms of a problem of capture and accounting. Is it possible to capture the value of such assets, and if so, how? Is it desirable to measure their value? Who actually requires such measurement, and to what end? Once again, the Value Paradox is this: intangible assets have evident value, yet this resists adequate capture. This paradox cannot be overcome, yet when we try to identify ways of managing it more effectively we note a series of methodological difficulties, as well as a number of perspectival ones. Ricardo Blaug and Rohit Lekhi (2009): A Research Report for The Work Foundation's Knowledge Economy Programme Research Republic LLP*

### Introduction

Merely thinking about transparency in financial reporting strikes fear into the heart of many a CEO. After all, public revelations call up the bugaboos of accountability and competitive exposure. But that is yesterday's thinking. In today's marketplace, greater transparency and better disclosure are keys in curbing the wild fluctuations and volatility of the world's stock markets, and ultimately, in increasing shareholder value. But there are certain things wrong with today's financial reporting. Instead of traditional financial statements prepared under generally accepted accounting principles, with independent audit reviews for accuracy and compliance with accounting standards, we now have a myriad of forward-looking and interpretive information without consistency of

---

\* Author Jamaluddin Ahmed PhD FCA is a Director of Emerging Credit Rating Limited and a Vice-President of Bangladesh Economic Association.

format and often, objectivity. What's more, traditional corporate reporting practices don't capture relevant market information and the non-financial measures that drive value. Today, financial reporting represents a shrinking percentage of the information that the market considers important. In fact, the flow of information has become entertainment with shows and networks devoted to "the market." From early morning to late evening there is a constant flow of information that, regardless of its reliability, can greatly affect the short-term fortunes of a particular company or market segment.

### **The case for Value Reporting**

It is established that traditional accounting and reporting models are inadequate in providing a full picture of corporate health, then companies need to shift the focus of their reporting. They need to supplement historic financial information with more information about value-building activities and non-financial measures. The big challenge for every company is the development of reliable and valid measurement methodologies for value-relevant, nonfinancial performance measures that have predictive value – measures that are an indication of how much shareholder value will be generated in the future. The Value-Reporting model is about broadening corporate reporting to have companies identify and meet analysts' and investors' needs for relevant information about value drivers, intangible assets and estimated future cash flows. Many companies have already started in this direction with new internal metrics. The use of the Balanced Scorecard approach, for example, is a step in the right direction but it is only a first step. A great deal more is required. The reality is that relatively little has been done to systematically address either the need or the process for providing information the market wants and needs to know.

The problem is that investors can't value what they don't know. They don't have the information to see the business as management sees it. They don't see the value of R & D, brand names, market share, employee satisfaction, customer retention and the intellectual capital of the business. Although companies generally do have a wealth of non-financial data that identifies and supports value, value reporting is not as straightforward as financial reporting. Whereas it's easy to report earnings-per-share, it's more difficult to crisply and objectively report value drivers like customer satisfaction, brand recognition and market share. The good news is that analysts, investors and corporate executives agree about the kinds of information that the market needs to accurately value companies, although the order of importance varies somewhat.

Each industry has different business drivers that help drive value creation. For example, the top ten list of relevant value drivers in the high-tech industry includes just three financial measures: earnings, cash flow and gross margins. Of the nonfinancial factors, three measures, strategic direction, quality/experience of the management team and speed to market, come from internal company data. The final four factors, competitive landscape, market size, market growth and market share require data that are not typically captured by internal systems.

Specific industry drivers might also involve capacity-utilisation such as rooms-occupied in the hotel or cruise ship industry, or seats-occupied on airlines and at entertainment events. They may involve productivity metrics in the professional services industry such as number of charged hours or rate per charged hour. While each industry tends to have specific drivers, each company within the industry may emphasize and focus differently on these value drivers.

### **Objective and structure of the paper**

This paper discusses on the aspects of value reporting and a way forward for it. In doing so this paper evaluates the existing literature on value reporting to identify the gap between the existing practice and stakeholder expectation. Given the objective, this paper discusses on the rationale of value reporting. In particular, it evaluates reporting on Earned value, Fair value, Embedded value, Enhancing audit report value and identified limitation thereof, Value addition reporting and its rationale, reporting value of acquired and intangibles, macroeconomic value reporting, corporate value creation, value of integrated reporting, Grant Thornton recommendation on enhancing value of audit report and a framework for corporate reporting. Finally, summary and recommendations.

### **1. Earned Value Reporting**

This section reviews the origins and concepts of Earned Value, followed by its application in traditional projects. It then investigates the application of Earned Value Management to Agile software projects. Historically, Earned Value is a project management technique to measure, at a specific date, the progress and performance of a project against the plan, and to estimate future performance. Earned Value considers 3 dimensions: 1) planned expenditures, 2) actual expenditures, and 3) budgeted expenditures for actual work accomplished. This provides a superior view into the project state than only looking at the first 2 dimensions. The concept of Earned Value began in the 1890's as the early industrial engineers measured performance in American factories. They defined a "cost variance" to relate "earned standards" against "actual expenses" to

determine performance. It was only in 1962 that Earned Value was formally introduced on projects by the US Navy, as part of the development of the PERT/Cost methodology. In 1996, a new set of criteria were produced to encourage adoption in the private industry, by making the criteria more 'user friendly'. The National Defense Industrial Association (NDIA) developed these 32 criteria and named it the Earned Value Management System (EVMS) criteria, currently embodied in ANSI/EIA

Finally, the Project Management Body of Knowledge (PMBOK), developed by the Project Management Institute, recommends utilizing a similar set of Earned Value criteria, as part of Project Cost and Project Communications Management (Performance Reporting).

## **2. Fair Value Reporting**

The new fair value hierarchy and related reporting disclosures had, and still have, the financial industry up in arms. Steps have been taken in order to align industry needs with FASB requirements, yet many questions still remain unanswered. Congress' concern of fair value reporting may insinuate that "fair value accounting may be less effective than historical cost accounting" which "is usually framed by the issue of relevance versus reliability" (Trussel & Rose 2009). Advocates of fair value accounting argue that current market measurements present figures that are more relevant than those of historical cost. Because reported amounts are more current, "investors and other decision makers can exercise better market discipline and corrective actions regarding a company's decisions" (Trussel & Rose 2009). Conversely, proponents of historical cost accounting dispute the reliability of fair value accounting, claiming that "fair value accounting leads to excessive volatility and short-term fluctuations that don't reflect the value at maturity and don't represent the fundamentals of the underlying financial assets and liabilities" (Trussel & Rose 2009).

When reporting the assets and liabilities of a company on a balance sheet, it is crucial that all amounts be accurate and timely. These two qualities are what SFAS 157 strive to improve. Incorrect asset and liability values not only reflect a faulty balance sheet, but they also skew the results of many financial ratios that analysts use in comparing organizations. By requiring companies to report assets and liabilities at Level 1, Level 2, or Level 3, using the various market inputs, comparability and consistency are increased by providing more detailed information in the financial statement footnotes without altering the balance sheet itself. Consistency of financial statements translates into reliability, which is a

crucial factor not only for the reporting unit, but for financial statement users, as well.

The continuous mayhem that currently exists within the financial markets today has been blamed on a number of factors, however, none more than that of fair value accounting. Fair value accounting is the reporting of assets and/or liabilities at the (fair) value for which they would sell in an active market. The idea of fair value reporting is not a new concept to the accounting profession. In fact, fair value practices have been in place for quite some time. Trading securities, for instance, have long been measured on an entity's balance sheet at their fair market value. Yet, what has changed is the recent turmoil within financial markets, which created a panic and caused a slowdown in market transaction activity. Very rarely in the past have accounting procedures received such harsh scrutiny from such a varied group of parties, which begs the question, if nothing has truly changed, what is all the fuss about? A large portion of the talk surrounding fair value accounting has "raised the temperature of the discussion while shedding very little light on the issues" (King 2009). The overall problem seems to be that reporting techniques have not changed, but markets that were once active where assets and liabilities were traded at easily identifiable fair values have now become inactive, posing significant valuation issues for companies that hold complex assets and liabilities. It has been argued that the amounts companies are required to report for certain items are not reflective of their true economic value; but, if the market the item is trading within is distressed, shouldn't that be reflected accurately within the financial statements? Strong challengers of fair value accounting boast that "if we do not halt the insanity of forcing financial firms to mark assets to a nonexistent market rather than their realistic economic value, the cancer will keep spreading and will plunge the world into very difficult economic times for years to come" (Isaac 2009). However, the goal of the newly enacted fair value reporting requirements is to increase the overall transparency and accuracy of financial statements, and by these accounts, it seems to be doing just that. Proponents of the new standard agree: "...those who blame fair-value accounting for the current crisis are guilty of the financial equivalent of shooting the messenger. Fair value does not make markets more volatile; it just makes the risk profile more transparent. We should be pointing fingers at those at Lehman Brothers, AIG, Fannie Mae, Freddie Mac and other institutions who made poor investment and strategic decisions and took on dangerous risks." (Levitt & Turner 2008), In response to the uproar surrounding fair value accounting, as a part of the Emergency Economic Stabilization Act of 2008, Congress mandated an investigation of mark-to-market accounting. Specifically, studies were to focus on

the effects of fair value reporting on companies' financial statements, the quality of financial information being provided, the bank failures of 2008, the reasoning behind the Financial Accounting Standards Board's (FASB) requirements, and any changes or alterations that could potentially be made to the standard (Congress 2008). In response, FASB Chairman Robert H. Herz stated: "we agree with the SEC and with our Valuation Resource Group that more application guidance to determine fair values is needed in current market conditions. Additionally, investors have asked for more information and disclosure about fair value estimates. Therefore, the FASB is immediately embarking on projects that directly address areas that constituents have told us are challenging in the current environment, and which will improve disclosures in financial reports." (FASB 2009) It is clear that there have been many modifications to fair value accounting practices since the issue first blew up. However, a new set of questions has risen to the forefront – what has changed with the additional guidance issued on fair value? Additionally, has there been a shift in the way in which assets and liabilities are classified?

### **3. Embedded Value Reporting**

Embedded value can be defined as the sum of:  $\bar{o}$  free surplus allocated to the covered business;  $\bar{o}$  required capital less the cost of holding required capital; and  $\bar{o}$  the present value of future shareholder cash flows from in-force covered business. It is inevitable that these elements are interlinked, because all assets supporting the portfolio are available to meet claims. Views differ as to whether the required capital forms part of the free assets which are constrained, and should be valued at less than their market value, or whether it is more appropriate to consider the cost of holding required capital as being as much part of the policy provision as the mathematical reserve. We note that this distinction is primarily presentational  $\bar{o}$  if the same valuation technique is applied to both viewpoints, the same result ensues.

Whilst the actual contribution to profit of a portfolio of life assurance business can only be measured once the last policy has left the books, the development of fast and readily accessible computing power has enabled the application of cash flow techniques to estimate future profit contributions of the portfolio. Anderson (1959) and others described techniques for pricing products and valuing the in-force business. As personal computers developed, so did the applications of these techniques for projecting or estimating the profitability of a portfolio. Typically, this was by means of a mathematical model in which 'best estimate' assumptions were made about future experience, for example relating to mortality, lapses, asset

yields, expenses and expense inflation, and projected surpluses were discounted at the shareholders' required rate of return. (The exact meaning of 'best estimate' has provided a topic for discussion within the actuarial profession. Deterministic estimates of the 'embedded value' of a portfolio have become common in the past 20 years, and the techniques can now be extended to produce an embedded value based on stochastic methods. The actuary of the early 21st century is, however, in something of a dilemma, in having to decide how to continue to develop valuation methods based on assessments of risk, or whether to use methods more directly calibrated to external market prices.

### **3.1 The Geddes Committee and Guidance**

The first Institute working party to consider the topic of embedded values was under the chairmanship of J. A. Geddes. This was established in May 1987, and reported to an Institute seminar in November 1988, with a written report being produced in February 1990. A principal objective of the working party was to consider the extent to which methodology and principles needed to be codified or prescribed. The report gives a good review of embedded value techniques, and the important questions which surrounded them, at that time. The report is candid, that there was a division of opinion amongst members on a number of topics. Geddes et al. (1990) contained recommendations on two levels of disclosure, the first being confidential disclosure by the reporting actuary to his principals/clients, and the second being public disclosure in financial statements and other published documents. The first level was considered to be a matter principally for the Actuarial Profession to decide; the second level would need to be discussed with both the accountancy profession and the life assurance industry, including parent companies which are not themselves assurance companies. Until the takeover of the Pearl Group (Pearl) by a subsidiary of the Australian Mutual Provident Society (AMP), embedded value accounting was viewed principally as a matter for the Actuarial Profession. The working party considered its role to be to provide the groundwork for the development of a more formal statement of recommended practice acceptable to the accountancy and actuarial professions, supported by a Guidance Note on the actuary's duties of disclosure and codification of technical methodology.

In 1989, AMP completed its successful bid for Pearl. In their sessional paper, Salmon & Fine (1990) described various issues which had arisen in this hostile takeover, suggesting areas where the Profession may have wished to become involved. The issue of the publication of an appraisal value was a key issue. Many believed that the final result of the takeover was detrimental to the shareholders

of the Pearl, because of the lack of published financial information until it was too late for it to be accepted and understood by the investment community. This triggered a number of listed companies into publishing more realistic information on a regular basis, with their efforts for standardisation being channelled through the Association of British Insurers.

However, the Profession has produced no more guidance, although many actuaries produced embedded value calculations, both as a value figure for use in transactions involving capital values, and as a tool for calculating the value added by management and management decisions in financial statements and other published and internal documents. The fact that there were a considerable number of embedded value calculations being made, some with published assumptions, led to a limited amount of convergence.

There were a number of subsequent sessional and Staple Inn meeting papers which discussed embedded value, for example Mehta (1992), Wright (1992), Collins & Keeler (1993), Sherlock et al. (1994), Mehta (1996), Simpson & Wells (2000) and Sheard et al. (2001). In particular, there were discussions on the appropriate method of establishing risk margins. In practice, the most important was the choice of the risk discount rate and its relationship with other economic parameters, such as the assumed investment returns and the associated rate of inflation.

Embedded value accounting did offer a number of advantages; by no means the smallest was that it provided a more realistic alternative to statutory accounting, under which new business strain had the effect that a successful and fast growing company appeared to be making greater losses than a less successful company. The embedded value method recognizes the expected value of the new business written. However, the European Commission Insurance Accounts Directive did not permit embedded value accounting, although some mitigation of new business strain was allowed through the use of a deferred acquisition cost asset. Banking groups were not within the scope of the Insurance Accounts Directive, and continued to use embedded value in their primary financial statements.

#### **4. Enhancing Value of Auditor Reporting**

Today's increasingly global and complex business environment and the turbulent events of the global financial crisis have highlighted the critical importance of credible, high-quality financial reporting. The current environment and events also have stimulated the demand for additional, and more pertinent, information about entities and the processes that support the quality of their financial



reporting. Existing shareholders, potential investors and others look to reduce the level of uncertainty in their decisions by seeking information they consider to be relevant and reliable.

Achieving high-quality financial reporting depends on a jurisdiction's financial reporting infrastructure put in place for that purpose. The legal and regulatory environment, including reporting rules and policies relating to corporate governance, the requirements of the applicable financial reporting framework, and standards governing behavior of participants in the financial reporting supply chain are all interrelated inputs to corporate financial reporting.

Equally, high-quality financial reporting depends on the decisions of those within individual entities who have responsibility for financial reporting—management and those charged with governance—about information that is made available to users. These decisions are made in the context of a jurisdiction's financial reporting infrastructure, with input from those charged with governance and the independent auditor. Continuous improvement in financial reporting requires an ongoing commitment by regulators, investors and other users, standard-setters and policy makers to review and strengthen the components of the financial reporting infrastructure process that they influence.

The external audit plays an important role in supporting the quality of financial reporting around the world, whether in the context of the capital markets, the public sector or the private or non-public sector. It is an essential part of the regulatory and supervisory infrastructure. At the same time, a number of factors influence what is and can be expected from the audit, and what can or should be communicated by the auditor to users of financial statements. These factors include the nature of financial reporting, the practical and legal limitations on the auditor's ability to obtain and disseminate information, and the need for the audit to be conducted within a reasonable period of time and at a reasonable cost.

Auditor reporting is only one element of the broader corporate reporting process, but plays an important role in communications with users. Accordingly, the value and relevance of the auditor's report needs to be monitored and maintained and, as appropriate, enhanced.

#### **4.1 Relevant Issues on Audit Report**

The issues raised go beyond the independent auditor's report on an entity's audited financial statements. Corporate reporting in several jurisdictions also includes narrative disclosures about an entity's financial condition and operating results and a wide range of other non-financial information made available to

users in a variety of ways, including through public filings. The debate has therefore also focused on the extent to which independent assurance regarding the reliability and completeness of this broader range of corporate information would help financial statement users to make more informed decisions.

Information gathered to date signals that: (a) The financial statement audit and the independent auditor's opinion on an entity's financial statements are valued. However, other than communicating the auditor's overall conclusion, the content of the auditor's report is not viewed as being as useful or informative as it could be.

(b) Users recognize there is richer information about the entity and about the audit itself than is currently being provided through the audited financial statements and other corporate disclosure mechanisms, and through the auditor's report. Users wish to obtain this richer information directly from the entity and/or through communications about the auditor's insight into such matters. They believe such information would assist them in assessing the financial condition and performance of the entity, as well as the quality of its corporate reporting and the quality of the audit. This is referred to as the "information gap." This is not the same as the expectations gap, but overlaps with it. Both are discussed further below.

(c) Some users also believe that the communicative value of the auditor's report could be improved if changes were made to the structure and wording of the auditor's report.

(d) There are many potential options for changes that might address these concerns, including some shorter-term options that fall under the IAASB's mandate and some longer-term options that would require co-operation with organizations whose mandate extends to other regulatory and legislative frameworks.

## **4.2 The Expectations Gap**

The "expectations gap" has been defined and described in a number of ways. In the broadest terms, the expectations gap is the difference between what users expect from the auditor and the financial statement audit, and the reality of what an audit is. This long-standing expectations gap often is attributed, in part, to a misunderstanding by users about the nature of an audit, including its scope, objectives and inherent limitations.

In particular, there continues to be a difference between public perceptions about the auditor's ability to detect financial statement fraud and the auditor's responsibilities relating to fraud under existing professional standards.

It also has been suggested that the expectations gap results, in part, from the manner in which auditors communicate their findings to users of financial statements. Because the standard auditor's report uses generic language to describe the auditor's work effort, users do not get a complete picture about the extent of the auditor's procedures on a particular audit and therefore feel left with a – gap  $\Pi$  between what is actually done and what they perceive is done in connection with the audit.

Academic research shows that user perceptions of audit quality are influenced by the communicative value of the auditor's report. The standard auditor's report provides little information to evaluate the quality of the audit, in part, because it does not disclose information about the procedures performed and the extensive judgments made by the auditor in forming the audit opinion. Increased transparency about the audit process may therefore have a beneficial effect on perceptions of audit quality.

### **4.3 The Information Gap**

Users of corporate financial information point to the existence of a gap between the information they believe is needed to make informed investment and fiduciary decisions, and what is available to them through the entity's audited financial statements or other publicly available information.

This – information gap  $\Pi$  has implications for the efficiency of capital markets and the cost of capital. The information gap is also seen as increasing the challenges of understanding how corporate financial information, including the audited financial statements and related disclosures, reflects the overall picture of the entity's financial condition, performance and sustainability of its business—an already considerable challenge especially in situations of economic turbulence.

Some suggest that the information gap is partially attributable to weaknesses in the financial reporting frameworks or their application, particularly in relation to disclosures that are key to users' understanding of the entity and its financial statements.<sup>4</sup> Nevertheless, many acknowledge that the complexity inherent in the business and reporting environment means that audited financial statements alone are unlikely to provide users with all the information they need for their financial analysis and decision-making.

Users recognize that the information available to them, including an entity's audited financial statements and the auditor's report thereon, is only a part of the wider information set available to management of an entity and/or to the entity's independent auditor. By design, through the established financial reporting

frameworks and relevant laws and regulations, this smaller subset of the available information is intended to provide users with a relatively concise summary of information relevant for their decision-making.

A perception exists that there should be more transparency about: (a) The entity and its financial statements, particularly key financial reporting risks and how they are being addressed; and (b) The audit performed, including key areas of audit risk. This leads to consideration of what the available, and most appropriate, channels are for narrowing the information gap by providing this type of additional information to users.

Conceptually, the perceived – information gap could be narrowed by the disclosure of additional information that is currently not available to users. In principle, such information could be provided to users through some combination of additional reporting by management or those charged with governance, or by the auditor. Some investors and analysts in particular, however, view the auditor's insight into the entity and its business obtained through the audit of the entity's financial statements as being especially relevant information for their needs, and have suggested that the auditor could report on the following types of additional information: Key business, operational and audit risks the auditor believes exist. The auditor's perspective on the key assumptions underlying the judgments that materially affect the financial statements, and whether those assumptions are at the low, most likely, or high end of the range of possible outcomes. The appropriateness of the accounting policies adopted, including any that are inconsistent with industry practice. Changes to accounting policies that have a significant impact. The methods and the judgments made in valuing assets and liabilities. Significant unusual transactions. Key audit issues and their resolution which the engagement partner documents in a final, summary audit memo. Quality and effectiveness of the governance structure and risk management.

#### **4.4 Explanations of Management and Auditor Responsibilities**

The standard auditor's report includes paragraphs that describe the respective responsibilities of management and the independent auditor. These paragraphs, added in the past to address some aspects of the expectations gap, are intended to provide essential contextual information for a reader's proper understanding of the auditor's opinion.

Academic research, however, indicates that readers perceive little information value in any content of the auditor's report other than the opinion on the audited financial statements. In particular, there is a view that those generically-worded

paragraphs do little, if anything, to bridge the expectations gap relating to the financial statement audit.

Some are of the view that these paragraphs could say more about the respective responsibilities of management and of the auditor (for example, regarding fraud, going concern, risk, non-financial disclosures or auditor independence). In particular, it has been suggested that providing an expanded description of the auditor's responsibilities for the detection of fraud would be especially helpful in addressing the expectations gap.

To address these views, one option would be to relocate these paragraphs to a separate document used to communicate with users about the financial statement audit. In doing so, the paragraphs also could be expanded as suggested in paragraph 40, as appropriate. Such a document, devoted solely to communication of such matters, could be made available electronically in a publicly accessible online location. An example is the model being used by the Auditing Practices Board (APB) in the United Kingdom.<sup>6</sup>

A second option would be to remove these paragraphs entirely from the report. This would result in what some have termed an "opinion-only" report. This would assume that readers are already sufficiently well-informed about the matters addressed in those paragraphs and need not be reminded when they read the auditor's report. Evidence suggests this is generally not the case, even in respect of sophisticated users.

A third option would be to retain these paragraphs in the auditor's report (and, as appropriate, expand their content), but position them at the end of the report, or as appendix thereto, while highlighting that such information is an integral part of the report. This may assist in enhancing the readability of the report while retaining what many perceive as essential contextual information.

Several arguments have been advanced for retaining these paragraphs in the auditor's report. Among other things, the auditor's report remains a stand-alone communication from the independent auditor. In addition, although the importance of this – one-stop communication may vary depending on the national liability regime, the inclusion of these paragraphs in the auditor's report promotes use of internationally consistent communications about the audit. Moreover, because these paragraphs were added to address the expectations gap, some have cautioned against their removal from the standard auditor's report. Those holding this view believe that removing these paragraphs entirely, in an attempt to improve the information value of the auditor's report, could in fact have the unintended consequence of widening the expectations gap.

In connection with these options for changing the auditor's report, others have commented on the need to develop educational material about the meaning of an audit and the role of the independent auditor that can be readily available to users. Over time, the availability of this information may relieve the need for such explanatory material to be included within the auditor's report itself.

#### **4.5 Use of Technical Language**

Academic research has shown that certain technical words used in the auditor's report (for example, – fair presentation,<sup>Π</sup> – materiality,<sup>Π</sup> – material misstatement,<sup>Π</sup> and –reasonable assurance,<sup>Π</sup> to name a few), appear to mean different things for auditors and for readers of the report.

There has been a call for wording used in the auditor's report to be less technical. Some have even suggested exploring whether explanations of technical terms and elaborations of key aspects of the auditor's report could be provided to assist users' understanding. A critical consideration in exploring this, however, is the extent to which further explanations may either assist or hinder readers' understanding of the auditor's report.

The idea of explaining more fully the meaning of technical terms might be explored in combination with the idea of providing a fuller description of the respective responsibilities of management and of the auditor. However, the more that is attempted in this area, the less likely it may be that it can all be accommodated in the auditor's report on the financial statements, therefore making it more likely that some degree of 'relocation' may be required.

#### **4.6 Location of the Auditor's Opinion**

It is acknowledged that the auditor's report needs to clearly communicate the auditor's opinion on the entity's financial statements. To many users, this is the key element of the report. The opinion is currently presented in the final paragraph of the report on the financial statements in the standard auditor's report. Some commentators have expressed the preference for the auditor's opinion to be given greater prominence. This could be accomplished, for example, through an –opinion-only <sup>Π</sup> report as described above or by presenting the opinion in the first paragraph of the auditor's report. Others have argued for the opinion to be positioned after the paragraphs dealing with the responsibilities of management and of the auditor, so that the opinion will be read with the appropriate context.

## 5. Value Addition Reporting

The concept of value added was initially used in 1790 in the first North American Census of Production (Gillchrist, 1970). Trenché Cox, a treasury official, whose techniques have since been adopted by most industrial nations in the calculation of Gross National Product (GNP), is regarded as the man responsible for realising that value added would avoid double counting. Value added has also been defined in the economic literature by Ruggles and Ruggles (1965). The VAS therefore, has a macro economic origin, in that the calculation of value added in the value added statement corresponds with the calculation of GNP, as well as economic significance. Suojanen (1954) defined the firm as an enterprise or decision-making centre for the participants, that is the enterprise theory. Accountancy's role in this regard is to report the results to the various interested parties in ways they can understand best. Suojanen suggested the value added concept for income measurement, as a way for management to fulfil their accounting duty to the various interest groups by providing more information than was possible from the income statement and balance sheet. This makes him one of the first writers to use the value added concept in terms of accounting for the results of an enterprise. Value added can be defined as the value created by the activities of a firm and its employees, i.e. sales less the cost of bought in goods and services. The value added statement (VAS) reports on the calculation of value added and its application among the stakeholders in the company. As such it introduces very little new information to that already contained in the income statement (salaries and wages used to be the only additional information), but it presents the information in a different and supposedly more understandable format.

In the United Kingdom, early forms of the value added statement functioned as part of a worker participation orientation towards the management of economic performance. It was important during the economic crisis of the immediate post-war era, but it disappeared during the prosperous years of the 1950s and the 1960s, only to return when similar strategic postures were adopted towards the management of the economy in the mid-1970s (Burchell, Clubb and Hopwood, 1985). According to Gray and Maunders (1980) the origins of the then recent interest in the United Kingdom in value added statements can be found in The Corporate Report (ASSC, 1975), which suggested the publication of a value added statement amongst other reforms. From 1977 onwards an increasing number of United Kingdom companies published the VAS, as has been established by various surveys of published financial statements (see for example Morley, 1978; Rutherford, 1978; and Gray and Maunders, 1980). In 1981 Burchell et al. predicted that the value added statement could lose its significance

again when the sociopolitical landscape changed. The research of Burchell et al. (1985) indicated that the incidence of publication reached a climax in 1980, but started declining after that. In the United Kingdom there were, therefore, definite trends towards and away from the publication of value added statements. A review by Gray and Maunders (1980) of the publication of the statement around the world indicated that a significant number of companies in the Netherlands, France and Germany provided value added data. They also noted growing instances of value added statements being disclosed in countries such as Denmark, Switzerland and Italy. An additional supportive

influence in the European context was the interest of financial analysts in value added data, especially in France. No further reference to the publication of the statement in Europe could be traced in the literature. In the United States of America and Canada companies have not published value added statements at all. Burritt and Clarke (1984) reported that the Australian approach to value added had been very cautious, showing nothing like the initial zeal in Britain. A few companies published value added statements (eight companies of the largest 100 in 1982, for example) as a regular supplement to the traditional accounts. Mathews and Perera (1996) reported that in New Zealand very few companies published a VAS as part of their financial statements.

### **5.1 Rationale for publication of Value Added Statement**

The VAS is regarded as a social disclosure, and therefore socially related arguments can be used to establish a theoretical case for publication. According to Mathews and Perera (1996) and Gray et al. (1995), these theories include organisational legitimacy, social contract and political cost theory. The concept of organisational legitimacy suggests that management can influence the perception that the stakeholders have of the organisation, and in this way obtain the support of those stakeholders without which it might be difficult for the company to continue to operate. The social contract of business with society is based on the premise that society provides corporations with their legal standing and attributes and the authority to own and use natural resources and to hire employees and that a social contract is therefore implied. Political cost theory is based on the premise that companies do have political visibility and that companies have an incentive to use accounting methods and disclosures to influence their political visibility. The social theories therefore indicate that management has an obligation and an interest to report to the other stakeholders. Although most of the accounting frameworks suggest this (for example the International Framework IAS, 1988) they do not require any financial statement or disclosures that will meet the needs



of stakeholders other than the financial participants and these disclosures have therefore remained voluntary. As value added statements in practice indicate how value added was allocated between various stakeholders, they might be considered to be interested in the value added statement. The stakeholders specifically addressed in the VAS are the employees, the capital providers and the government.

Most of the literature on the value added statement indicates that it was aimed primarily at the employees. This was anticipated by the Corporate Report, published by the Accounting Standards Steering Committee (ASSC) in 1975, when it described the value added statement as the “simplest and most immediate way of putting profit into proper perspective vis-à-vis the whole enterprise as a collective effort by capital, management and employees ...” This move away from reporting on profits only, is supposed to make the financial information more relevant and understandable to the other stakeholders. The VAS therefore became known as a disclosure aimed at uninitiated and unsophisticated users of financial information. In addition, a number of surveys have been conducted among companies publishing the statement (for example, Purdy, 1981; Joubert, 1991; and Stainbank, 1992) These surveys found little evidence of actual use. The companies used the statement mostly for employee communication and wage negotiations. A survey was conducted during 1998 among SA companies to establish why they are publishing the VAS. The companies were selected on a random basis and 94 responses were received. The following are the five reasons given by most companies, in order of importance:

- To be used in corporate communication with employees
- To earn points in annual financial statement awards
- To indicate social responsibility on the part of the company
- To facilitate wage negotiations and collective bargaining
- To condition employee expectations

Therefore, it would appear that the social theories require management to report to the other stakeholders and that management have these stakeholders, and particularly the employees, in mind when they publish the VAS. The VAS is also an ideal vehicle to change perceptions of the company as it is unregulated and normally not audited, and can be used by management to condition expectations. Unfortunately, this aspect has eventually led users to mistrust the statement (for example, it almost always indicates that the labour component takes most of the value added (Hird, 1983)).

## 5.2 Market Related Arguments

Based on a normative approach of profit maximisation as the primary aim of an organisation, and the decision usefulness approach to the publication of financial information, annual financial statements have been primarily aimed at the financial participants in the company, being the shareholders and the creditors. Even recent accounting frameworks (for example the International Framework) have not had a significant impact on this and the other stakeholders have been largely disregarded (see also Mathews, 1997). The publication of the value added statement could therefore be motivated if it has additive or predictive value for the financial participants.

Although many studies have investigated the link between social disclosures and market indicators, the results have been conflicting. This is perhaps not surprising considering the difficulty in explaining investor reactions using economic theory. On the one hand Friedman (1970) argued that the “social responsibility of business is to increase its profits” and warned that social expenditure that reduced profits could have a negative impact on investors. In contrast, it has been argued that investors will reward firms engaged in social activities by investing in them even at the risk of lower returns (Milne and Chan, 1999). It is therefore difficult to form an expectation of investor reaction, as different investors will have different expectations.

Mathews and Perera (1996) reported on studies done in the period from 1971–1984. These studies all attempted to relate some measure of social responsibility to measures of market performance. The studies looked at measures ranging from subjective indicators of social performance to objective indicators as reported by outside parties. They concluded that “although the findings from a number of studies are conflicting, it may be argued that the overall weight lies towards a view that the disclosure of non-traditional information does have utility for shareholders and the security market. However there are other, perhaps stronger, arguments in favour of social accounting disclosures.” Gray et al. (1995) found from studies done during the period 1979–1990 that corporate social reporting (CSR) disclosures did not appear to be related to profitability in the same period, but might be related to lagged profits. They also reported on decision-usefulness studies done on CSR information during the same period and concluded that despite some studies indicating that CSR information is not useless, the decision usefulness approach to investigating CSR has been largely unsatisfactory. Milne and Chan (1999) confirmed this by stating that little is actually known about the investment decision impact, or for that matter any decision impact, of social disclosures. They found from a review of the research

that there was no consistency in the market reaction studies and that it was doubtful whether these studies provide strong support for the proposition that social information is useful for making investment decisions.

Considering value added statements specifically, value added information is expected to have an impact on the external indicators of the company as it indicates how the value added of the company is allocated between the various stakeholders. As the shareholders will perceive the other stakeholders to be in competition with them for a share of value added, they can be expected to react negatively if the other stakeholders get too much of the value added. If, on the other hand, the value added statement indicates that any of the stakeholders has not received a fair return, it could also impact on the future share price (Gray and Maunders, 1980). Although this is perhaps not the strongest argument for decision usefulness, it has already led to a number of research studies in this regard. From 1990 to 1996 Riahi-Belkaoui conducted a series of studies investigating the link between value added information and market indicators in the USA. With Karpik (1990) he established that value added accounting information could supply considerable explanatory power of market risk beyond that provided by earnings or cash flow measures, especially at the individual firm level. In 1993 he established that value added information can supply some explanatory power of security returns beyond that provided by earnings or cash flow measures. He did a similar study with Picur (1994) in which they concluded that value added information can supply important explanatory power of security valuation beyond that provided by earnings. In 1996 (1996a) he found that value added information published concurrently with earnings did have additive information content. In the same year, (1996b) he found that value added-returns relationships offered better explanatory power than the earnings-returns relationships, when the relationships were expressed by a non-linear, convex-concave function. In 1996 (1996a) he also found that productivity (as measured by value added) did not provide information about future profitability incremental to that provided by current profitability. This finding seems to be surprising considering his earlier findings.

In other studies in this area, Boshoff (1996) found that value added information did not have predictive power with regards to share price and price earnings ratio. Bao and Bao (1996) examined the time series properties of value added as well as the prediction accuracy of the value added series. They found that the random walk model, which indicates that the effects of the factors that affect value added, and the direction of the changes, are not predictable, best fitted the value added measures and was consistent with that of annual earnings and share prices.

In a South African study Van Staden (1999a) examined the predictive and explanatory power of value added information in comparison to earnings for three external indicators over a five-year period. The external indicators were share price, price-earnings ratio and Altman's Z chosen with regards to importance, risk and future success or failure. All companies that published a value added statement for three of the five years were included in the sample. As already indicated, this represented a significant percentage of companies listed on the JSE (more than 30%). The aim of the study was to establish if value added had additional predictive and explanatory power beyond that provided by earnings, which is already a disclosure requirement for companies. Value added for the year as well as changes in value added was used in the statistical analysis. As value added as published by the companies is not calculated and reported in a consistent way, gross and net value added were calculated for each company in a standard way and in addition value added as published by the company was also used. This gave rise to three value added measures which were each tested individually against the external indicators. The study found meaningful correlation and regression between the value added measures and share price, but it was not more significant than the correlation between earnings and share price. As multicollinearity between the value added measures and earnings was observed, they cannot be used in combination to improve on the predictive power of earnings.

## **6. Reporting the value of acquired intangible assets**

Partly driven by recent high-profile reporting-related scandals, accounting bodies around the world have been steadily shifting financial reporting to more of a fair value/market to market basis. As part of this shift, there has been a significant and steady change in the accounting for business combinations, specifically in the area of the treatment of intangible assets. Intended to introduce increased transparency into business acquisitions, this trend—led by the summer 2001 introduction in the US of similar standards FAS 141 (Business Combinations) and FAS 142 (Goodwill and Other Intangible Assets)—reflects the fact that acquisition prices are frequently considerably in excess of the value of the net tangible assets acquired and it is questionable to call all of this balance goodwill when typically it is represented by other intangible assets capable of reliable measurement.

### **6.1 Brave new world?**

The newly introduced IFRS 3 is a very significant extension of this shift to enhanced transparency. Its impact should not be underestimated. All EU companies on listed exchanges will be required to report under IFRS from 2005

and, at the same time, many other countries including, for example, Australia, are also adopting these same standards. IFRS is therefore becoming the new accepted language for financial reporting. There are also significant pressures to converge the US and International Financial Reporting Standards to establish one set of global standards.

Principal changes of IFRS 3 at a glance:

- All business combinations are to be accounted as acquisitions - no more merger accounting.
- Goodwill is no longer amortised but subject to rigorous annual impairment tests.
- More intangible assets will be identified, valued and recognised on acquisition.
- Detailed disclosures about transactions and impairment testing are required.

Where accounting for intangible assets is concerned, a major problem until now has been that, while there is more or less global consensus that accounting for IP is an issue that demands attention, there has been less agreement on how these assets should be recognised and accounted for. This means that the same company's balance sheet can look completely different under different jurisdictions' accounting rules, notwithstanding the fact that each purports to show a true and fair view. The additional disclosure now mandated by IFRS 3 means that the market can expect to receive valuable in-depth information, helping them to assess more accurately exactly what companies have acquired. However, it should also be pointed out that, while this is clearly a positive step, a major gap still exists in the reporting of intangible assets because no jurisdiction yet allows a company to place a value on its internally generated intangible assets.

## **6.2 Goodwill no longer amortised**

One of the most significant changes introduced by IFRS 3 is the fact that intangible assets other than goodwill that are recognised on the balance sheet will either be amortised over their useful life (hitting the profit and loss account and reducing earnings) or, if appropriate, assigned indefinite lives. Assets given an indefinite life will not be amortised, but will have to undergo an annual impairment test. The criteria for indefinite lives are strict, to the extent that few assets can be expected to meet them (see below). IFRS 3 has also changed the rules for residual goodwill. Goodwill is no longer amortised, but is instead subjected to a stringent, annual impairment test. In the event that it is impaired, an immediate charge will be taken to the profit and loss account, so poor performing acquisitions will be highlighted through such a charge sooner rather than later. This represents a fundamental shift in the way goodwill is viewed. Goodwill is seen no longer as a steadily wasting asset, but instead as one that should be expected to maintain its value.

### **6.3 No more pooling of assets – the end of merger accounting**

Another key provision is the compulsory treatment of all business combinations as purchases – abolishing the choice of using the pooling of assets method (or merger accounting), which allowed companies simply to pool their balance sheets together, thus not recording any goodwill. This development may well have a very significant impact. For example, five of the six big pharma companies underwent defining mergers in the last seven or eight years – and all of them were treated as mergers and not acquisitions.

### **6.4 Purchase price allocation (PPA) now required in all cases**

Under IFRS 3, recognising acquired intangible assets separately on the balance sheet is to be carried out as part of a purchase price allocation. Before IFRS, the difference between price and book value was goodwill. This goodwill bucket contained, inter alia, all the internally generated intangible assets (eg, brands and patents) which had not been capitalised by the acquired company. All these assets will now have to be identified, valued and separately included on the balance sheet. The list of Principal changes of IFRS 3 at a glance

- All business combinations are to be accounted as acquisitions - no more merger accounting.
- Goodwill is no longer amortised but subject to rigorous annual impairment tests.
- More intangible assets will be identified, valued and recognised on acquisition.
- Detailed disclosures about transactions and impairment testing are required.

intangible assets that will have to be separately recognised as a result of IFRS 3 is very extensive (see box). IFRS 3 demands that the identification and valuation of intangible assets should be a rigorous process. Those preparing accounts under these standards should also bear in mind the fact that, under Financial Accounting Standards Board (FASB) Standards 141 and 142, the SEC can, and does, call for the working papers supporting a company's purchase price allocation and underlying valuations, and has the ability to ask for the work to be re-performed if they consider that the requirements have not been complied with. Similar strict implementation is to be expected when companies report under IFRS.

### **6.5 Impairment reviews**

Under IFRS 3, goodwill is no longer deemed to have a finite life and is therefore not amortised. Instead, it is treated as having an indefinite life and is reviewed for

impairment at least once a year. Other intangible assets may also be deemed to have lives, but this is rare and usually limited to certain trademarks. Most intangible assets other than goodwill are amortised over their expected useful lives. Assets given an indefinite life will have to undergo an annual impairment test. Unlike the situation in the

US under FAS 141 and 142, the IFRS test is a one-stage process, based on value in use (or value to the current owner), as opposed to the two-stage test in the US which is based on fair or market value. Detailed disclosure will be required in relation to these annual tests including the assumptions underlying the impairment tests and, potentially, how sensitive the result of the impairment review is to a change in any of these assumptions.

Therefore, management needs to be aware that shareholders and analysts will have more information to assess acquisitions and ask difficult questions in relation to their post-acquisition performance and the reasonableness of the impairment reviews. Some indication of the likely impact of these impairment tests can be obtained by looking back at the experience of some companies reporting under US GAAP, and being forced to make some significant impairment charges (under FAS 141 and 142). A case in point from the early days of FAS 141 was Telefonica. When the Spanish telecom giant restated its accounts under US GAAP, its originally announced net profit of €2.11 billion under Spanish GAAP turned into a net loss of €7.18 billion. The main reason for this huge difference was the need for writing down goodwill relating to acquisitions (including that of Lycos).

## **6.6 Useful life**

The fact that most intangible assets (other than goodwill) are amortised over their expected useful lives imposes another burden on management – the need to determine the expected useful life of each of the assets acquired. Lining is an important process and management will want to pay careful consideration, particularly to the assets which may be ascribed an indefinite life (ie, the ones which will not be amortised but tested for impairment annually, like goodwill). Brand names are a good case in point. If the brand has been around for ages, enjoys high awareness and is a market leader (eg, a leading soft drinks brand), it will be relatively straightforward to ascribe an indefinite useful life for accounting purposes. Similarly, where last week's latest high-tech gadget is concerned, there will be little difficulty in ascribing a fairly short, finite useful life. Anything in between these two extremes is, however, likely to prove troublesome. Management should bear in mind that difficulties in accurately determining an intangible asset's useful life do not provide a basis for regarding that useful life as

indefinite. Concluding upon a useful life requires careful consideration of the circumstances as well as judgement. An indefinite life assertion needs to be backed by evidence and analysis supporting that no legal, regulatory, contractual, competitive, economic or other factors limit the life of the asset. Examples of such evidence might include internal and external empirical data (eg, lifecycle studies, market, technological and other trends; and renewal and extension patterns), as well as the opinions of valuation and industry experts. In light of the guidance provided by IFRS 3, it is envisaged that indefinite-lived assets will be rare. It is worth noting that following the introduction in the US of FAS 141, which includes similar guidance on lifing issues, the authorities there expressed surprise at the larger-than-expected volume of assets being ascribed indefinite lives.

### **6.7 Impact on earnings**

Goodwill and intangibles constitute a majority proportion of the value of most companies. In light of this, there can be absolutely no doubt that the introduction of IFRS 3 is set to have a very real impact on earnings. Under the accounting standards that formerly applied in many countries, a significant proportion of the cost of an acquisition was typically allocated to goodwill, which was then amortised, typically over a period of 20 years. Under IFRS 3, no amortisation of goodwill could lead to a positive short-term effect on earnings. However, when companies complete deals under the new standard, less of the cost of acquisition will be allocated to goodwill. More intangible assets identified in new transactions, that are amortised over their useful lives, may well result in higher amortisation than if the cost of acquisition had been allocated to goodwill. This is because several of the intangibles typically recognised tend to have lives significantly shorter than goodwill (eg, contractual and non-contractual customer relationships, order backlog, non-compete agreements, software etc). It is therefore likely that, in a number of cases, the acquiring company's earnings will be lower than those expected as a result of identifying, valuing and amortising intangible assets. In addition, impairment charges will inevitably inject more volatility into the market, with the result that earnings are likely to fluctuate more than ever before.

Following the introduction of the US equivalent standard and consequent large impairment changes, management in some cases tried to downplay the significance of goodwill writedowns and pass them off as irrelevant and non-meaningful given that they are non-cash and one-time, blaming them on some obscure accounting change. Indeed, for analysts focusing solely on cash flow, these write-downs should not matter greatly. Also, ironically, these charges clean



up the balance sheet and can result in significantly improved return on equity in subsequent years. However, a large charge does indicate to investors that a company has overpaid for an acquisition.

Furthermore, large equity depletion may have implications for debt covenants. In addition, EPS, which is directly affected by such charges, is still used widely as a performance indicator and in some cases has an impact on directors' remuneration.

So how can management deal with these issues? It is important that those concerned with policy making and deal structuring are fully aware of the impact of IFRS 3 on the P&L and balance sheet. In many situations, there will be some flexibility in structuring a deal, which can allow for managing this impact, and ensuring that it is consistent with overall corporate strategy. There might, for example, be a trade-off between the level of earnings and the risk of large impairment charges. The higher the combined amount of goodwill and indefinite-lived intangibles, which are treated similarly to goodwill (not amortised) and differently to definite-lived intangibles (amortised over their useful life), the lower the amortisation charge and, thus, the higher the profit. However, having large amounts of goodwill-like assets on the balance sheet increases the risk of impairment.

Before a transaction, decision makers are best advised to carry out thorough analyses of the current and projected value of goodwill and intangibles to be acquired, based on the postmerger business plan. At the transaction and PPA stage they need to exercise care, for example when it comes to defining the acquired mix of definite and indefinite-lived intangibles. Post-transaction, implementing a robust IP value measurement and management system would enable management to monitor the value of the intangibles at regular intervals, thus resulting in better performance management – as well as providing an early warning when things go wrong, and allowing for corrective action to be taken.

## **6.8 IFRS v US GAAP**

Although the IASB and the FASB have worked to remove as many of the differences between IFRS and US GAAP as possible, some differences remain. The date of an acquisition under IFRS is the date on which control physically passes (whereas in the US, it is the date on which the agreed deal is announced). Under US GAAP, in-process R&D acquired must be immediately expensed, while under IFRS this asset is capitalised and amortised (assuming certain criteria are met). Thus, US GAAP profits take a hit immediately following an acquisition,

while those under IFRS smooth this over the next few years. And there are key differences, as already described, between the two-stage US impairment test and the one-step process under IFRS 3.

## **7. Macroeconomic value reporting**

Many economies are becoming knowledge based: competitive advantage and organisational performance is moving from investment in physical assets and low skilled labour to investment in intangible knowledge based assets such as R&D, design, brand equity, software, and human and organisational capital. For many organisations investment in such intangibles now equals or exceeds their investment in tangibles such as buildings, office equipment, hardware, machines, and vehicles.

These changes have thrown up four major challenges in how we account for such assets: Firstly, despite decades of debate and effort, it has not proved possible to find a way of accounting for such assets in the same way as, say, investment in a machine. This is what we call in this report the ‘value paradox’ – recognising the value of such assets but being unable to account for them through conventional accountancy rules. Investors, shareholders, and managers will in consequence make less well-informed decisions. Secondly, much of the debate has ignored SMEs and focused on the corporate sector because it is here that improvements in reporting, recognition, and management of intangible assets have been seen to have the greatest relevance. But the shift towards knowledge activity is even stronger among SMEs than large firms.<sup>4</sup> Yet SMEs face even greater problems than corporate in accounting for intangibles. Thirdly, economists and others have increasingly recognised that the conventional models based on the national accounts definitions of investment in physical assets were only giving a partial account of growth, investment and productivity. And when intangible investment has been recognised, it is often focused exclusively on scientific R&D – as defined by the OECD. Important though R&D is, it accounts for less than 10 per cent of all intangible investment by business. Fourthly, we know next to nothing about investment levels or the treatment of intangible investment by the public sector – even though the two public based knowledge industries of education and healthcare account for around 40 per cent of value added produced by knowledge intensive industries in the UK. As well as all the problems identified for private organisations, public organisations have a further set of dilemmas: for example, how far they can legitimately exploit their intangible asset base to generate additional revenue.

In the knowledge economy, and in knowledge-based firms, much value lies in what accountancy practice refers to as ‘intangible assets’. Knowledge, know-how, human capital, informational data, reputation and organisational practices are examples of such assets. They are ‘intangible;’ meaning they cannot be ‘touched;’ they cannot be grasped like material assets; they cannot be easily costed, counted and quantified. The nature of the knowledge economy, and the importance of intangible assets within it, is neatly summarised by Stanford economic growth theorist Paul Romer:

*‘How can it be that we are wealthier today than people were 100 years ago?. . . This question is puzzling because, if you add up all the things we own, it is clear that the underlying quantity of raw materials has not changed over time,. . . The total physical mass here on earth is the same as it has ever been, and now we have to divide this up among a much larger group of people. So how could it be that we have more total wealth per person than we ever did before? ...There’s only one explanation for this increase in wealth. We took this raw material that was available to us and rearranged it in ways that made it more valuable. We took stuff that was not very valuable and made it much more valuable. . . What lies underneath this process of rearrangement are instructions, formulas, recipes, methods of doing things – the things accountants classify as intangible assets if they recognize them at all. They tell us how to take something that is not very valuable and rearrange it into a new configuration that is more valuable.’*

Knowledge-based businesses rearrange. They generate their main cash flows from their investments in intangibles rather than from the traditional exploitation of physical assets and relatively low-skilled labour. As we shall see, macro-level analysis clearly demonstrates that intangibles create value, and investments in intangibles certainly yield returns above the cost of capital. Why else would business enterprises invest so heavily and consistently in R&D, employee training, brand creation and maintenance, organisational change, and other forms of intangible asset if this was not the case?

Despite their evident value-creating capacity, however, the case for capturing and representing that value within existing accounting practice has proven hugely controversial. In part, such controversy reflects ‘philosophical’ differences about the nature and role of accounting practice. On the one hand are those for whom the primary role of accounting is to assure a coherent representation of past performance, while others suggest that when faced with a knowledge based economy, traditional accounting acts to obscure a whole array of intangible drivers of value, and thus fails to anticipate future value-creation. As a consequence, for some, accounting is seen to require nothing short of a revolution in its ability to grasp the fundamentally distinct (forward) drivers of value growth in today’s economy.

Lev (2001)<sup>7</sup>, one of the primary advocates for reform of accounting practices around intangible assets, suggests that such assets are now the primary drivers of modern economic activity. As a consequence, their absence from traditional financial statements leaves investors with insufficient information on which to make informed decisions about the (past and future) performance of a business. Indeed, Lev goes further, claiming that the lack of accurate reporting on intangibles has probably led to the 'systematic undervaluation of intangibles,' and as a result, also to insufficient levels of investment in these core assets. We thus face a situation in which we know intangibles are valuable, but cannot say how. Or more accurately, we can say *many* things about how, but none can adequately satisfy the demands of traditional accounting practice for verifiable quantification of risk and reward. This paradox, between something we actually use to create value yet which escapes adequate demonstration or quantification is referred to in this report as the *Value Paradox*. The Value Paradox is inherent to the knowledge economy. It is universal and cannot be solved. As we suggest below, there is no 'golden' metric for intangible value, and accountancy is not designed to deliver one even if there was. Where traditional accounting tools function as a guide to *past* performance, the focus on intangibles needs to be oriented to *future* value creation. This is not to say that research should not be undertaken to improve methods of accounting for intangibles at the firm level, only that their value can never be entirely captured in numeric representations.

Yet what we need is not so much a new or larger coat, but to liberate value-creation from the constrictions of a system of value reporting that is in fact oriented to an industrial economy. To escape the inaccuracy of analogy, what are now required are *new methods of value-creation*. To this end, this study argues that value creation in the knowledge economy is most fruitfully conceived in terms of innovation: here in the ways in which intangible assets are invested in. New products, services and processes that are generated by the innovation process (such as new drugs or internet-based distribution channels) are the outcomes of investment in R&D, acquired technology, employee training, customer acquisition costs and other intangibles. Certainly, intangibles are inherently difficult to trade, their legal property rights are often hazy, contingent contracts are difficult to draw up and the cost structure of many intangibles (large sunk cost, negligible marginal costs) is not conducive to stable pricing. Accordingly, at present, there are few active and organised public markets that enable trade in intangible assets. While this might eventually change – perhaps, for example, facilitated by internet-enabled exchanges – it will still require specific enabling mechanisms, such as valuation and insurance schemes. Once again, then, while private trades in intangibles proliferate, they do not provide adequate information

for the measurement and valuation of intangibles in general. The key to achieving substantial improvement in the disclosure of information about intangibles is thus to construct a comprehensive and coherent information structure that focuses on the big picture – the value creation (innovation) process of the enterprise – and places intangible assets in the proper role within that structure. This study therefore attempts a shift in focus from the dilemmas of reporting to an approach that focuses more on enabling the sorts of changes and reforms that are already identified as helpful, but are currently stifled by the pre-occupation with getting standards and measures absolutely right.

Often, it is used interchangeably with ‘intellectual capital’ or ‘intellectual assets’. Such confusion reflects not only the nature of intangible assets, but also the complex constituencies that are involved – investors, accountants, academics, policy-makers, consultants and firm representatives – and their different and sometimes competing interests in managing, measuring and reporting intangible assets. Investors tend to employ more specific terms such as ‘reputation’ and ‘brand equity’ rather than consider intangible assets in their entirety. Research shows that, internally, while managers appreciate the importance of company resilience and managerial competency, they tend to not consider these virtues as examples of intangible assets. Even advocates of a more schematic approach have tended to confuse the issue. The Enhanced Analytics Initiative, for example, has taken intangible assets to subsume socially responsible investment issues – a different, though related concept.

More recently, categorisations of intangible assets have broadened considerably, beyond the more ‘traditional’ intangible assets, such as patents, software and trademarks, to include more dynamic elements of businesses such as human resources, organisational competencies and business processes oriented to innovation.

Thus, guidelines published by researchers from European universities under the EU Meritum project, for example, identify three distinct categories of intangible assets: ‘human capital’ refers to the knowledge and skills of employees, such as the amount of employees with a PhD; ‘relational capital’, referring to the consumer, supplier and research networks that are open to the firm – such as consumer loyalty, previous business or research collaborations; and ‘structural capital’, (ie the organisational competencies of the firm) – such as its intellectual property and infrastructure assets.

The non-physical nature of these assets has, however, continued to thwart efforts to quantify their exact value. Again, the Value Paradox is not something that can

be 'solved.' Financial statements and reports of physical assets no longer provide comprehensive analyses of knowledge-based firms, and this is certainly problematic for investors, accountants, shareholders, management and policy-makers alike.

Moreover, the broadening of definitions to include more dynamic issues further compounds the difficulties of valuation. Indeed, ambiguity continues between the intangible assets themselves – such as patents and trademarks – and their 'value drivers', ie the organisational competencies and networks that will effect whether or not the former are utilised to their full potential. Furthermore, the various components of intangible assets can be deeply intertwined, making them difficult to isolate and quantify. (Lev and Daum, 2004). On the whole, policymakers have largely failed to appreciate the extent and diversity of intangible assets and their preoccupations have often been restricted to an almost exclusive focus on R&D. This in part reflects a long-standing paucity of existing (systematic and comparable) macroeconomic data on intangibles within the international System of National Accounts. While a 1993 revision of the SNA did incorporate a number of hitherto excluded intangible assets – such as software, artwork and mineral exploration – its scope has remained relatively narrow (Schreyer, 2007). As a result, certain R&D expenditures have been taken to constitute consumption expenses within existing national accounts. Recent revision of SNA in 2008 has sought to address this issue incorporating measures of R&D capitalisation. However, this immediately begs the question of why stop with R&D capitalisation? For example, staff training and other intangible assets are just as risky as R&D and equally important for value creation. Indeed, companies invest in a host of intangible assets other than R&D to enhance their technological capabilities and bring innovative products to the market (Baldwin et al, 2004). The growing challenge for national accounting bodies will be to provide a more expansive account of the role of intangibles in the (macro) economy that is better able to capture their diversity in a systematic and comparative form.

## **8. Reporting Corporate Value Creation**

The motivation for the valuing and reporting of intangibles at the firm-level generally revolves around the claim that many contemporary businesses are 'knowledge-based', in that they generate their main cash flows from their investments in intangibles rather than primarily from the traditional exploitation of physical assets and relatively low skilled labour.<sup>27</sup> For example, Lev (2001)<sup>28</sup>, one of the primary advocates for the reporting on intangibles, suggests that 'intangibles' are now the primary drivers of economic activity and that as a

consequence of the absence of intangibles reporting in traditional financial statements, users have insufficient information on which to base rational investment decisions. Indeed, Lev goes further and claims that the lack of reporting has probably led to significant under-investment in intangibles, ie, the 'systematic undervaluation of intangibles' by investors; and that radical reforms to the reporting model might be the catalyst for generating higher and economically worthwhile levels of investment in such assets. Lev is not alone in making these claims, or in calling for accounting reforms to more adequately disclose firms' investments in intangibles. For example, the CEOs of the world six largest accountancy firms have also suggested that, because the market values of firms typically far exceed their book values, this provides 'strong evidence of the limited usefulness of statements of assets and liabilities that are based on historical costs' (DiPiazza et al., 2006, p 16). This same report calls for more 'forward looking', ie, 'predictive' information relating to 'how well a company will perform in the future: innovative success ... measures of customer satisfaction, product or service defects or awards, and measures of employee satisfaction (perhaps approximated by turnover)', (DiPiazza et al., 2006, p 17). According to this view, then, accounting measurement is not a sufficient basis for the strategic management of the firm. Rather, the firm needs to set goals and track performance using a broader framework of analysis. This involves decomposing market capitalisation into current and future growth value components, and creating systems to track that future growth in all of its dimensions (market, customer, human, structural, etc.). Where firms recognise the limitations of traditional, transaction-based accounting, they have sometimes moved to measure and disclose the 'fair value' of their intangible assets. This, in turn, leads them to use a broader set of metrics, now including measures for customer, human and structural capital. These metrics are derived by decomposing market capital into current and future growth value components, and enables the measurement of future value creation streams. Indeed, there has been no shortage of attempts to develop such stand-alone measurement frameworks, and currently, there are at least 80 different value and performance measurement schemes on offer.

The proliferation of value frameworks, their different conceptions of intangibles and their varied weighting of values, all attest to the difficulties faced by any attempt to account for intangible assets within the firm. These difficulties are widely aired across the relevant literature and can be categorized as pertaining to issues around the identification of intangible assets, problems accounting for goodwill, how R&D is accounted for and how brand reputation is to be measured. We here take each in turn.

Current international standards for intangible accounting are highly complex. For the firm to have created an intangible asset, it must be identifiable, separable and reasonably expected to generate some future economic benefit. Under IAS38, the current international accounting standard that covers accounting for intangibles, an intangible asset is defined as '*an identifiable, non-monetary asset without physical substance*'. Further, any intangible asset must also fulfil the criteria of an ordinary asset as set out in the IASB Conceptual Framework of being '*a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity*'. Investment in R&D or training does not therefore automatically result in the creation or acquisition of an intangible asset as it is not clear that this investment will result in any future economic benefit to the firm.

Companies must also control the asset to allow for the firm to gain any future economic benefits, and do so with a high degree of certainty. In many instances, this can be achieved through the protection of intellectual property (IP), which gives the firm legal rights over a specific technology or process through patent or copyright. Although such legal control is intuitive for technological innovations, however, it is not so for other forms of intangible asset, such as training and knowledge spillovers. The ability of the firm to secure future economic benefit from such assets is, therefore, rendered uncertain.

Even when the firm has a copyright or patent, these must still fulfil the asset criteria, as well as being identifiable. Again, the condition of identifiability is not straightforward. As IAS38 states, an asset is identifiable when the firm has control over the asset, or it can be separated from the other assets of the firm. To be classed as separable, the asset must be '*capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged*'. Under this definition, for example, goodwill is not an intangible asset as it is not identifiable. To actually recognise an intangible asset on the balance sheet, all the above criteria must be met and the cost of the asset must be estimated. In these circumstances, the cost of the asset is usually the cost of acquisition – such as the purchase of a franchise or the cost of generating the asset such as R&D. However, to estimate the expected future economic benefits of a given intangible asset, IAS38 allows managers to apply discretion to arrive at the best approximation of the revenues that the firm expects to gain. If intangible assets are purchased, the issues surrounding recognition are reduced, as the total cost is the price paid for the asset plus any costs that are directly related to the purchase. The price then reflects the expectations of any future economic benefit that that asset might generate.



Firms can also generate intangibles internally. Yet again, such assets are difficult to accurately identify and cost. IAS38 is, however, explicit that *'internally generated goodwill shall not be recognised as an asset'*. Research and development are therefore considered to be different parts of creating an internally generated intangible asset. IAS38 defines the research phase as *'original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding'*. By so defining research, any costs incurred are expensed when they occur. Classifying research in this way is consistent with the standard and takes on what constitutes an intangible asset. This definition is also intuitively appealing, as there is a high degree of uncertainty as to whether any initial research would actually lead to any future economic benefit. The development phase of a project is defined as, *'the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use'*. At this stage there is a much higher likelihood of there being an identifiable asset, and managers are able to demonstrate that the asset will result in some economic benefit flowing to the firm. If, however, it is not possible to identify an asset at the development stage, then any development costs that are occurred must be expensed.

Clearly, the complexity of accounting for intangible assets in the knowledge economy presents accounting with a major challenge. However, despite all the different criteria and methods for accounting for intangibles, there are two further issues that may exacerbate the problem of consistent financial reporting of such assets. These complexities in current accounting practices are made more difficult when confronted with issues of managerial discretion and 'fair value' mechanisms for asset valuation. one hand, critics allege that the use of managerial discretion in estimating the future economic benefits of intangible assets that a firm may reasonably expect could be problematic. If managers' expectations are unreasonably high, their assets will be valued and reported at too high a level, and therefore the meaningfulness of financial reports will be reduced. On the other hand, the use of 'fair value' amounts contributes to the difficulty of ascertaining future economic benefits. Under IAS38 and IFRS3 fair value is defined as *'the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction'*. While this may seem uncontroversial, critics claim that the use of fair value accounting is problematic and adds a layer of complexity to the already difficult task of asset valuation. The reliance of 'fair value' on quoted market prices, means that distorted prices – caused by market (dis)stress or illiquidity, for example – can be

uncritically taken to represent the actual value of the assets concerned, regardless of what their 'true' economic worth might be.

The value relevance of R&D has been fully explored in the accounting literature. Numerous studies have shown that equity prices and future returns are positively related to research and development in the firm (Hirschey and Weygandt, 1985; Lev and Sougiannis, 1996). Also, there is a tendency noted in accounting research for markets to overestimate the value of R&D relative to the increased earnings derived. The extent to which the market may overestimate the value of R&D is highlighted by the findings of Sougiannis (1994). For a \$1 increase in R&D, market values increase on average by \$5. Yet earnings only increase by \$2. Investors cannot, therefore, properly assess the potential future benefits of R&D investment. The reporting of R&D and the inherent riskiness of these investments is not properly understood. This was highlighted by Kothari *et al* (2002), who show that relative to future cash flows from tangible assets (property, plant and equipment), future cash flows from R&D are much riskier. Shi (2003) considers R&D increases from the perspective of bondholders to assess if the benefits outweigh the risks. The results show that from the perspective of bond holders the risk of the uncertain payoffs from increases in R&D outweigh the benefits. Interestingly, the study finds that around 80 per cent of the cross-sectional variation in bond ratings and risk can be explained by R&D components. These results suggest that increases in R&D increase shareholder wealth at the expense of bond holders by increasing firm risk [Eberhart *et al* (2007)].

However, Eberhart *et al* (2007) find that Shi's results (2003) are dependent on the measurement of R&D used. Applying a better measure of R&D and a more sophisticated analysis, they show that the net effect of R&D is positive for bondholders; ie the increase in firm value from increases in R&D offsets the increase in firm risk. Further, those firms that have the highest probability of default are found to benefit most from increases in firm value that come from increases in R&D. This is also the case where the level of bank debt in the firm is higher as covenant protection is much more stringent. Another option that firms historically exploited in structuring R&D was the creation of a research and development financing organisation (RDFO). By so doing, R&D is essentially undertaken in another corporate form: as either a limited partnership or a corporation. These structures offer potential tax and reporting benefits, yet Beatty *et al* (1995) found that the benefits of such structures are far from clear. Such methods can only point to marginal tax benefits and can, due to high levels of informational asymmetry, create adverse selection problems.

**Table: Example of Glaxo-SmithKline, (GSK)****The impact of research and development on firm value: the case of pharmaceuticals**

Pharmaceuticals are an industry where research and development, protected intellectual property and regulatory approval are crucial. Where a firm has a drug under patent the implications on firm value of gaining regulatory approval are significant. In looking at pharmaceuticals as a case study the impact of R&D on firm cash flows and also the costs of undertaking such investments become clear. Glaxo-SmithKline, (GSK) a large UK pharmaceutical, gained approval from the Federal Drug Authority (FDA) for the sale of Altabax, a topical cream for impetigo in April 2007. FDA approval in this case was the first approval by the FDA for a prescription only tropical antibacterial in almost 20 years. Altabax clearly has a number of advantages relative to the other treatments that are currently available as it requires only two applications per day for five days. Most other treatments need to be used for around ten days and require more applications on a daily basis. This improved effectiveness is crucial as impetigo is a highly contagious skin infection that generally affects children between two and six and so the shorter treatment time with fewer applications makes treatment much more effective. The process of getting the drug to market however was not smooth. In 2005 the FDA said that it would require more testing to be carried out before regulatory approval was granted despite the firm having carried out successful clinical trials on 700 patients. In the third phase of clinical trials involving 210 patients the drug was shown to have an 86 per cent success rate.

Analysts estimate that with European approval, which was announced by GSK on the 1 June 2007, that the drug could generate worldwide sales of £150m per annum by 2011. Upon the announcement of the FDA approval the share price of GSK closed up by some 2.4 per cent giving the firm an estimated market value of £84bn (and increase of almost £2bn). In looking at the case of GSK it is clear that intangible assets and protected intellectual property can be very lucrative for firms. Further, the market clearly values these assets where a tangible revenue stream has been identified and secured. In fact, the drug was available as early as 2005, but was only approved in 2007. Implicit in this are significant costs in getting any drug to the market and there is clearly a high level of risk that approval would not be forthcoming in the end.

Brand names and reputation are significant assets for many firms and firms clearly trade on these. Google, for example, has an estimated brand value in excess of \$86bn.<sup>35</sup> However, once again, to properly value and account for this is problematic, here exacerbated by the wide range of stakeholders with competing needs. From the perspective of the firm, branding and reputation create competitive advantages for products that are easily substitutable. One such example is training shoes; Nike clearly generates significant value through its brand and customer loyalty. This is done through

creating relationship based assets through the development of a psychological link between the customer and the product.<sup>36</sup> How, though, do we value brands? In recent years there has been a good deal of work that aims to value brand. However, no method is wholly satisfactory and most require managerial judgement and discretion.

This review of current work seeking to capture the value of intangibles at the firm level reveals enormous conceptual complexities that continue to prevail over theory and practice. In a helpful summary of the broad theoretical challenges that remain for those attempting to capture the 'true' value of intangible assets, Kim (2007) suggests that there are four core concerns that will need to be addressed. These are:

1. Aggregation problems: these arise from the often incommensurable nature of various intangible assets. How do we delineate between management and scientific knowledge when in practice these exist in the mix? Moreover, while some intangible assets are amenable to quantitative measurement, others can only be represented in a qualitative form.
2. Depreciation: Little is known about the depreciation pattern of intangibles. Moreover, intangible capital depreciates both internally and externally. So, for example, the appearance of a new technology may lead to the depreciation of an old technology at an irregular and unexpected speed. How and how much intangibles depreciate (or, put differently, how fast they become obsolete) is often simply assumed rather than underpinned by rigorous evidence.
3. Human capital: While firm specific human capital should be treated as an intangible assets belonging to the firm, the general skills embodied in a person can leave the company when that person leaves. However, how can human capital which is firm specific be separated from other general skills in micro-level valuation exercises?
4. The relationship between intangibles: Many researchers have found that there are clear complementarities between tangible and intangible investment. However, there has been little research, and hence little is known, on the interaction and complementarities between different intangibles. The relationship between intangibles is bound to be more complicated than the one between tangibles and intangibles and it is likely that contribution of intangible assets as a combined whole is greater than the sum of the contributions of individual intangible capital items alone.

## 9. The Value of Integrated Reporting

Sustainability is a business practice important to all businesses of all sizes that is beginning to impact across the entire supply chain, as more and more global firms begin to see securing a green supply chain as a strategic priority. Integrated reporting increases the transparency of the organization, highlighting the issues and the impacts towards governance and structure.

Sustainability is more than just an over-used term or business practice for global organizations. It is a business practice important to all businesses of all sizes – globally. Sustainability is the ability for companies to cut the umbilical dependency on ever increasing environmental resource demands and cut costs delivering ethical, sustainable, economic growth over the longer term. This business practice is founded on sound business sense delivering improved value to all stakeholders – the company, employees, customers and wider societal groups.

In order to be effective and deliver the desirable value generating results it is essential to report both the strategy and the policy actions, creating meaning and credibility to the outcomes. Sustainability mitigates against future risks and creates a continued license to do business. Without the passport of sustainability, companies tread the boards of high risk through the contagion of poor business practice, leading ultimately to business exclusion.

How so? In the recent **Carbon Disclosure Project** 2011 Carbon Disclosure Project Supply Chain report, the numbers of companies who will de-select suppliers now for not having sustainable credentials has doubled over the 2010 report. This has been further buttressed by the recently released report ‘Green Supply Chain: from awareness to action’, from the consultancy **BearingPoint** Ireland, which indicates: *‘two thirds of companies surveyed in Europe believe that a green supply chain is a strategic priority.’* Furthermore, over half of the respondents in the survey said they did not renew contracts with suppliers who did not respect their green charter.

Moreover, throughout the great recession of 2007 – 2010, there has been a dislocation of trust between companies and the global communities they serve. Emerging from the recession – any company wanting to repair such dislocation has used sustainability as the model to achieve best results.

Notwithstanding this disconnect, the financial crisis in the main was brought about by short-term demand on profits (UNPRI) and a lack of focus on long-term value creation. Compounding these issues further was short term and inadequate

structures to monitor the environmental and social impact of the company, financial structuring and management practices.

Therefore, whether it is customers, companies want to engage, or investors through the reduction of risk, or employees to improve team cohesion, drive innovation and attract best talent from the ascendant eco-boomers; sustainability connects all the interdependent functional areas in a more holistic manner, driving down costs – delivering on-going value through the introduction of a continuous cycle of improvement.

And, the pressure being applied to the supply chain now is the result of large corporate bodies needing to realign on sustainable best practices and controlling the risk of the supply chain by removing companies demonstrating poor environmental and social practices. Furthermore, the momentum for these moves has been caused in part by the pressure being applied, from society, on the license to do business and part through the momentum of mandatory reporting. Examples of such mandatory acts are: Climate Change Act and the Carbon Reduction Commitment Energy Efficiency Scheme in the UK, Grenelle Act in France, Sustainability reporting law in Finland, King Code III in South Africa as well as many others across the globe.

Indeed, for global companies to survive and prosper, they need to ‘green’ their businesses to compete in an ultra competitive world, and this includes their supply chain, as exposure to a sustainably poor supplier will damage reputation and deliver the message to society, that for all the apparent sustainability efforts, ultimately there was no control.

However, sustainability is not just about mitigating risk, it is about opportunity. As stated earlier, reporting on sustainability forces actions and meets the needs of achieving cost cutting and value creation over the long term. Learning to deliver higher quality, more efficient products and services from a more efficient and optimized base of resource utilization.

**So, sustainability addresses the triple bottom line of: Environmental, Social and Economic:**

**Environmental** – reducing emissions and bio-diversity impact

**Social** – training and improved team cohesion of the human capital; further combined with societal improvement through investment in communities.

**Economic** – extended competitive advantage and value, long-term economic growth through improved trust, ethics, operational optimization and innovation.

Credibility of the company takes place particularly after the publication of the first report – detailing the sustainability base line, the actions, goals and intended outcomes. Once reported, it forces the enforcement of the policy. Reporting forces the company to set robust and meaningful KPIs and forces a behavior change with the resulting environmental improvements illustrating a sustainable development reality of sagacious leadership.

In contrast, companies believing they can develop a green mirage by ticking a few boxes and communicating efforts in the vaguest terms without proof of delivery, execution and the continuous cycle of improvement will fall prey to the more sophisticated buyers who are keen in identifying ‘window dressing’. The practice of half hearted commitment will be a danger to reputation – eroding trust and competitive advantage. Notwithstanding this, poor reporting, or no reporting, will show over time, words do not equal actions and results, leaving perceptions to adjust downward, showing the underlying reality of a sustainably poor company with poor governance.

Additionally, the EU over a number of years has consistently emphasized sustainable development to build trust between businesses and society to improve competitiveness. Following this lead, managers from companies in the vanguard of sustainability use their reports as tools to build better and more effective networks and communications across stakeholder groups. The reports become effective business tools as they deliver against market demand and expectation for transparency and make the companies more accessible. In response, the report providing companies gain a reputation for responsible corporate behavior.

What we see here is the evolution of sustainability creating an evolving and improving cycle of competitive advantage as sustainability has been shown to retain and attract best employees as, experience has shown, highly qualified eco-boomers come to the work market from university, they are choosing whom to work for with more consideration as to the values of the employer, making sustainability a major factor in decision-making. Business is going to have to adapt to the changing requirements and needs of the workforce and its ability to attract best talent as people revise their goals, priorities and expectations as they look to make efficiencies in how and where to live and work – as, commuting is less attractive with the associated impacts of time, cost and emissions being factored. Moreover, with best talent there is a natural progression toward evolving products and services reducing customer impact and building further the bonds of trust and legitimacy to operate, delivering long term value creation and, moving away from the corrosive past economic and business models.

Whilst market forces are driving the reporting agenda, this has been in part led by regulation, and it would be naive to think the regulation imperatives are going to melt away. On the contrary, they are on a sharp curve to engage all businesses quickly – each nation needing to meet challenging and agreed emission reduction targets. The quickest way to meet these targets is through operational excellence – reducing energy, water and waste whilst benefiting communities in reducing poverty and poor health. To decouple economic growth from current emissions growth curves is not a difficult concept, just one that needs embracing. The winners are embracing sustainability now and inoculating their businesses from investment and market exclusion. The losers will be the ones who just don't get it.

Furthermore, pervasive market and Governmental demands on sustainable development ensures the metrics needed to create meaningful and robust reports are being elevated to the same rigor as financial reporting. This in its self is leading to, and causing, new requirements for company law and accountancy rules. With reports being used as business tools, it is further leading towards managerial creativity around new ways of building brand and reputation to meet with the new customer and other stakeholder demands and expectations.

These market forced actions underpinned in 2010 by the establishment of the **International Integrated Reporting Committee (IIRC)**. The objective: to establish a global reporting framework for ESG (Environmental Social and Governance) information in a clear, concise, consistent and comparable manner. *“Integrated Reporting demonstrates the linkages between an organization strategy, governance and financial performance and the social, environmental and economic context within which it operates. By reinforcing these connections, Integrated Reporting can help business to take more sustainable decisions and enable investors and other stakeholders to understand how an organization is really performing.”* IIRC.

For example: **Ernst and Young** recently issued a report indicating an increase in the number of shareholder resolutions focused on sustainability. The report: ‘Shareholders Press Boards on Social, Environmental Risks’ claims shareholders are paying closer attention to environmental and social matters as they bear closely upon the risk companies are exposed and therefore ultimately on financial performance of these companies. In short: shareholder resolutions that garnered at least 30% support (30% being seen as critical mass) on social and environmental issues rose from just 2.6% in 2005 to 26.8% in 2010.

Naturally, this momentum is also found in the investment market place where ESG issues are gaining critical importance in determining investment funds – understanding fully the risks to future income, trust and reputation. It has been



shown; intermediaries in capital markets are increasingly integrating ESG data into valuation models. And, evidence suggests that sell-side analysts generate more positive recommendations for firms that score high in ESG credentials. In conclusion, sustainability is not restricted to companies valued through stock markets. Their supply chains are part of that valuation, and so all companies are involved. Society is demanding a repair of the dislocation of trust. And this is a wonderful opportunity for business, the environment and society to benefit.

Sustainability and its reporting will increase the transparency of the company, highlighting the issues and the impacts towards governance and structure. It acts as a catalyst for positive change to internal management practices and creates incentives to better manage relationships with employees, investors, customers, suppliers, regulators and society.

Whilst sustainability highlights risks, it also by default spotlights the opportunities – to increase efficiency, reduce energy, water and waste through operational optimization; within the boundaries of the company as well as the supply chain – whilst also exposing any human rights violations.

Sustainability inoculates a business from market exclusion as customers have already shown to be turning their backs on socially and environmentally irresponsible companies.

Sustainability is about building long-term relationships and long-term economic growth, for the company engaged in sustainable behavior and the eco-system in which the company is embedded.

#### **10. Grant Thornton recommendations on Enhancing the Value of Auditor Reporting: Exploring Options for Change (Oct. 18, 2011)**

Grant Thornton has submitted its recommendations to the International Federation of Accountants (IFAC) on Enhancing the Value of Auditor Reporting: Exploring Options for Change. The consultation paper seeks to determine whether there are common views among users of audited financial statements and other stakeholders about the usefulness of auditor reporting.

“Grant Thornton favors enhancements to the auditor’s report that would increase the usefulness of the information provided to stakeholders,” said Trent Gazzaway, Grant Thornton LLP’s Audit managing partner. “An enhanced understanding of the needs of the readers of the financial statement, audit report and other information made available to stakeholders may also lead to bolder changes in the financial reporting process and the role of the auditor.

“In exploring substantive change to the audit reporting, we encourage the IFAC to develop a holistic, principles approach that we describe in our cover letter to determine the type of reporting that would narrow (and not increase) the expectations gap.”

External reporting by an entity and its auditor is a complex subject. Entities strive to produce accurate and complete information, at a reasonable cost, to meet the needs of stakeholders while balancing the need to protect their business from competitors using the disclosed information to the entity’s disadvantage. Auditors need to respect the confidentiality requirements of the entity and provide the stakeholders with a clear message regarding the fairness of the entity’s financial statements, taken as a whole.

The foundational concept to external reporting is that management reports and auditors enhance the value of those reports by providing independent assurance. This long-standing concept and practice has served stakeholders and society well and we believe it should be retained.

Grant Thornton feels that determining the actions to take to enhance the value of auditor reporting need to be based on following principles:

A holistic approach to determine the actions needed to enhance external reporting, which involves determining the incremental reporting needs of stakeholders, assessing who should be responsible for the reporting, determining the benefits and costs of the reporting and whether assurance on the reporting would add value. This approach would also involve providing criteria for the incremental reporting to enable entities to meet disclosure objectives and enable auditors to opine on the information, if assurance is desired.

The management of the entity is responsible for meeting stakeholder’s expectations regarding information about the entity. Auditors should disclose entity-specific information only when management fails to report information as required by the reporting framework or criteria.

The entity’s auditor is responsible for disclosures about the audit process. Additional disclosures aimed at narrowing the expectation gap and should:

Relate directly to the audit process. For example, stakeholders may desire greater transparency about the role of component auditors in the audit of the group and such information could be provided in the audit report.

Communicate clearly the level of assurance provided, if any, on additional disclosures. The auditor’s views about aspects of the entity’s disclosures based on the audit procedures performed in the financial statement audit should be

presented in a manner that does not mislead the stakeholder to believe that these views are presented with assurance. For example, such views could be expressed in a report that is separate from the financial statement audit opinion.

The entity's auditor is responsible for disclosures about the audit process. Additional disclosures aimed at narrowing the expectation gap and should not:

Be a surrogate for information about the entity. For example, one of the suggested enhancements under consideration is reporting on areas where the auditor had difficulties on reaching a conclusion. In seeking such reporting, stakeholders may be less interested in the audit process and more interested in measuring an unspecified attribute about the entity. We refer to this situation as "surrogate for information about the entity." In the case of "difficult audit areas," stakeholder may be seeking information such as the complexity or aggressiveness of the entity's financial reporting or the appropriateness of the entity's resources or the adequacy of the entity's controls. Any of these items could result in audit difficulties as auditor disclosure of information about the entity would not be appropriate. Stakeholders would be better serviced by a direct measurement of the desired information and by having that measure performed and disclosed by management.

Mislead stakeholders. For example, disclosing the auditor's quantitative materiality could mislead the reader as the application of qualitative aspects of materiality applied by the auditor during planning, execution and evaluation are omitted and the complexities associated with the application of materiality to certain measurement uncertainties may not be understood.

Increase the expectation gap by confusing stakeholders or casting doubt on the appropriateness of other auditor or management disclosures.

Grant Thornton also believes that stakeholders are equally interested in incremental and different disclosures with respect to the entity. We therefore encourage IFAC to work with other necessary stakeholders in a holistic manner in its efforts to address the reporting expectation gap.

## **11. A framework for effective corporate reporting**

What information should a company gather and report? A framework for effective corporate reporting has four main elements:

**Market Overview** - provides management's take on the company's external market. Although no one can predict the future, investors want to know what the company's leadership thinks the future holds. This should typically include the competitive environment, the regulatory environment and macroeconomic environment in which the company operates.

**Value Strategy** - explains in detail how the company will compete in its marketplace, and outlines its strengths and weaknesses, goals, objectives, governance and management.

**Managing for Value** - reports on financial performance and position benchmarked against competitors and peers, risk management, and segment results.

**Value Platform** - details how well a company manages its tangible and intangible assets, including innovation, brands, customers, supply chain, people and social and environmental reputation, to create value.

In developing measurement methodologies, a company must focus on its unique industry metrics and concentrate on those that best fit the company's strategy. Although many industry groups are working independently in this area, there is a great deal of work to be done in establishing non-financial metrics by industry and general standards around the development and calculation of such metrics. The Canadian Institute of Chartered Accountants is leading a global initiative to try and develop global standards for value creation drivers. It is working with other major accounting bodies and the large global accounting firms to identify the key value drivers and risks and to set global standards to assess and compare them. The accounting profession, with its global reach, must play a critical role in bringing about these changes in external reporting.

For the majority of companies who are not amongst the chosen few, there is a need to bridge the communications gap. There are five identifiable gaps in getting their word to the street:

*The Information Gap.* The difference between the importance that analysts and investors attach to a value measure and how satisfied they are that their information needs in regards to that measure are being met by company managers.

*The Reporting Gap.* The difference between the importance that managers attach to a value measure and how actively they work to report on it.

*The Quality Gap.* The difference between the importance that managers attach to a value measure and the reliability of the information provided by their internal systems.

*The Understanding Gap.* The difference between the importance that managers attach to a value measure and the importance that analysts and investors attach to it.

*The Perception Gap.* The difference between how actively managers think they work to report on a value measure and how analysts and investors perceive the

adequacy of the information they get on it. In order to increase their visibility, companies need to start addressing their circumstances relative to these five communication gaps. They need to recognise where a gap exists and to address the need.

The lack of effective communications and the current failure of companies to report non-financial information place them in peril. Executives who feel their company's shares are undervalued should seriously consider whether it's because of a lack of relevant information. Is the company being transparent enough with its critical value drivers? Customers, shareholders and potential investors will make decisions about companies whether they use accurate data or not. If companies don't provide information, someone else with suspect reliability may, with resulting damage to a company's stock.

Value-Reporting requires a real change from corporate executives and boards of directors, charging them with the responsibility of ensuring that all material information about the company is disseminated as quickly as possible to all interested parties simultaneously. Companies must develop sound measurement methodologies for the key non-financial drivers and intangible assets that the market finds most important. They must communicate the resulting information in an organized and structured way. In the end, we must move away from the Earnings Game to an environment in which the value drivers are visible. Once we do that, we will be able to improve the allocation of capital and our ultimate economic health.

## **12. Forward thinking**

IFRS 3 is clearly a positive step, boosting M&A deal transparency and forcing management to take the management of their intangibles more seriously than ever before. The investment community is likely to penalise companies that fail to address the impact of IFRS 3 coherently and constructively. The onus is on management to provide robust IFRS numbers, and to explain them convincingly. From now on, effective due diligence means carefully assessing the intangible assets within potential targets, as well as properly taking into account the financial impact of any proposed acquisition. It is clear that the introduction of IFRS 3 will have very significant business implications for both CFOs and CEOs. From now on, they need to understand and be able to communicate how acquisitions will be accounted for, as well as explain precisely what has been acquired. As a general observation, senior management is likely to find itself coming under much greater scrutiny from the investment community on all future deals. The overriding advice is that management needs to understand the issues involved and plan ahead

in order to take advantage of opportunities, create headroom and avoid unpleasant surprises.

### **13. Summary and Recommendations**

To be an effective communication device, the audit report urgently need reducing communication gap in terms of information, reporting quality, understanding and perception.

The primary focus must be on improved company reporting of intangibles in a more consistent and comprehensive way: whatever the theoretical benefits of changes to accountancy practice, efforts to find a practical way forward have not proved successful; Trade associations and other business organisations have a role in encouraging greater consistency and making sure that the value of intangible investments is widely recognised by firms, investors, shareholders and managers.

BIS already publishes league tables of investment in R&D based on company reports, a valuable source of benchmarking and information. The department should consider extending this approach to other intangible investments where sufficient information exists;

As suggested in the 2009 White Paper, *New Jobs, New Industries*, the government should encourage the development of new financial institutions at both the national and local level to meet potential funding gaps for knowledge intensive, intangible rich but physical asset poor SMEs;

New advice services should be developed to help SMEs make the best use of intangible assets: the work of the Intellectual Asset Centre in Scotland is one example of how this could be done;

There should be a cross-cutting audit of the public sector's intangible asset base as part of the next Spending Review. A key objective would be to identify how the public sector can make best use of the intangible assets it has at a time of overall spending austerity, including new forms of revenue raising;

The government should publish annual estimates of intangible investment by major sector, building on the reports published by HMT and BIS; and support the ONS in developing more robust measures for inclusion in the national accounts and international comparisons.

There is mileage in exploring the idea that as part of new institutional arrangements focused on delivering high value, knowledge based growth, there should be a national knowledge bank.