

Corporate Reporting - Without Shades of Grey

The 'earnings game', that is reporting results with an eye on the stock markets has caused a lot of grief although empirical studies show that it may not even be necessary to play the game at all. The relationship between meeting or beating earnings estimates and stock market rewards are, at best, tenuous. Investors are disillusioned with earnings estimates, quarterlies and the like and are demanding much more information from companies about issues that really matter to them, issues that create value.

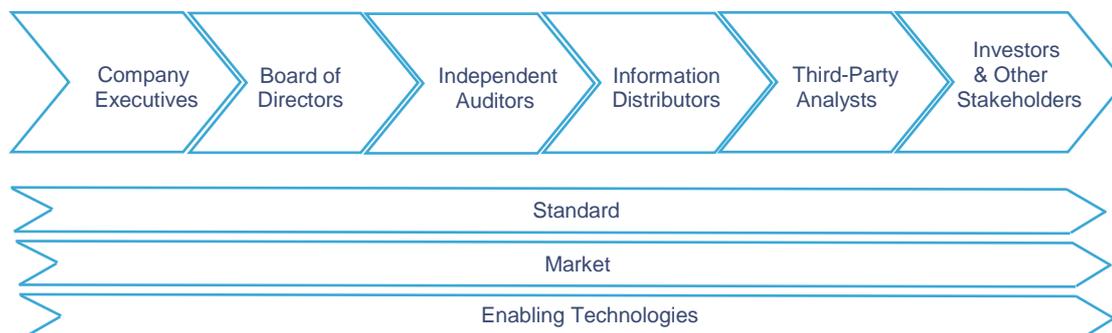
Companies that provide fuller disclosure increase the transparency of working and ultimately help restore trust in the quality and integrity of information that it distributes, that is move to a corporate reporting standard that is not painted in shades of gray.

Over the years, corporate reporting has become a labourious and voluminous exercise with corporate reports running into hundreds of pages. But has it improved clarity or provided valuable insights into the business? As companies struggle to outdo each other in the length and volume of its reports, readers are subjected to 'carpet bombing' of information. Readers, in turn, struggle to make sense of the information being provided even as corporate reports risk blocking transparency instead of enhancing it.

This is not to say that corporations actively try to obfuscate clarity of information. Modern businesses are too complex and too vast to lend themselves to any simplistic model of reporting. Diverse internal information systems and various non-integrated software are major blocks to a streamlined, reliable and fast information exchange.

This is where the concept of The Corporate Reporting Supply Chain can be really understood as defined by Samuel DiPiazza and Robert Eccles , in their book, *Building Public Trust: The Future of Corporate Reporting (2002)*. Just as you have a distribution supply chain for physical goods, consider a supply chain of information with many components,

distributors and consumers. Being a chain necessarily means that there are a number of links that go into its making, as illustrated below:



The foremost of these groups, the first link in the chain, that is, company executives and board of directors must shoulder the biggest challenge for starting on the difficult path of putting into practice transparency in corporate reporting.

Reporting with transparency and without shades of grey calls for integrity of individual executives within the company, for, the integrity of the whole system is merely the sum of the integrity of individual players. Even so, there are a few nodal points that company executives must specifically address at all times so that the supply chain functions smoothly, such as:

- **The reporting gap:** This refers to the significant gaps that exist between what management thinks is important in running a company and what it reports to outsiders. There exists an information gap between how important investors think certain indicators are and the information they actually get. This gap is overlaid by another gap – that is how important management thinks certain indicators are and how much they report that information. Yet another gap is about what management wants to communicate and how its information system is geared for gathering the information. Attempting to reduce this gap will help end the ‘earnings game’ significantly.
- **External value drivers:** There are many areas, especially in formulating corporate strategy where companies have to rely on information generated from outside the company. For example, estimates of political stability in a country where the company proposes to make large investments over the next few years can

only be generated from outside sources like government agencies or foreign news bulletins.

Such outside information is useful in putting together an overall picture of its performance, as well as comparing performance with its peers.

- ***Lifting the corporate veil:*** Modern businesses have become too complex for a company to engage in end-to-end operations on its own. Networking with partners, using common research facilities or even outsourcing some operations are all a part of running a successful modern business. Investors must be told how each level of business operates and how it impacts the consolidated fortunes of the company. At times it is difficult to estimate where the original entity ends and the partner alliance begins. For example, if a pharmaceutical company has outsourced human trials of a major drug to another company, the success of that second company is very relevant to investors of the original company. Investors would want to know details about the other company even though they do not have any direct investments in it. Current provisions of GAAP or other standards do not adequately address such relationships and it is up to individual companies to display high standards of governance in reporting these kinds of dynamics.

Value Reporting- Raising the Bar

Current reporting mechanisms cannot be faulted for being out of tune with modern requirements. After all, this model of accounting and reporting was developed over many years to cater to an industrial era. The focus has been on tangible assets and liabilities and is essentially a report card of events that have already occurred.

This model, however, is increasingly unsuited to modern businesses, particularly those in the so-called New Economy. Intangible assets like brand value, knowledge base, networked relationships, patents or even supply chains are crucial elements that may well be the difference between success and 'also-ran'. For instance, the value of an idea can energize the entire potential of a business, venture capitalists may be willing to invest millions into the company on the basis of that idea but old economy measurement yardsticks are incapable of measuring and translating its true worth into recognizable values.

Traditional reporting measurements suffer from two major flaws and they are:

- They are historical in nature and deal with has-been events, mostly of a financial nature.
- They recognize only linear relationships. Performance indicators, however, react in many different, often complex, ways and many a time throw up relationships that are not straightforward cause-and-effect relationships.

Financial measures are ‘lagging’ indicators, popularly explained by the metaphor of trying to steer a car by looking into the rearview mirror. Users of information need inputs about financial as well as non-financial information. This is equally important for people within the company as for outsiders.

In the early nineties, Robert Kaplan and David Norton of Harvard Business School introduced the world to the concept of a ‘*balanced scorecard*’ as a measure of performance and management. Simply stated, a Balanced Scorecard performance measurement system is one that allows executives to view a company from many perspectives simultaneously. By combining financial and non-financial measures in a single report, the balanced scorecard aims to provide managers with richer and more relevant information than with financial measures alone.

Kaplan and Norton’s model, popularly known as *first-generation balanced scorecard*, tried to establish links among objectives, measures, targets and initiatives among four perspectives, namely Financial, Internal Business Processes, Learning, Growth and Customers. All these factors were centered on the company’s vision and the strategy it followed. The authors of this model proposed that the number of measures in a balanced scorecard should be limited in number and clustered into four groups.

This model was developed largely for use by the company to improve its internal management process and not really for external reporting. Kaplan and Norton introduced the concept as a *strategic management system* rather than a reporting or communication tool.

The greatest advantage in developing and using a scorecard, tailored to suit specific needs, is that it recognizes the complex relationship that performance measures have with each other. Many corporate decisions impact issues other than company finances, some of which may even be inversely proportional to each other. For instance, a company that decides to outsource some of its back office operations to a different location, say, Bangalore, to harness the benefits of lower costs ends up being responsible for job losses in the original location and may have a human

resources problem on its hands. Or consider a company that sources raw materials from a developing country to bypass local home country regulations. The company's policies could actually be responsible for encouraging unhealthy labour practices or causing serious environment damage in that other country.

Enabling Technologies

After a company has tackled its 'earnings management' and embarked on the road towards value reporting, there is an important area of accounting reform to be addressed and that is the way information is delivered. Users still have sift through mountains of data, supplement official corporate information with data from second-hand sources, most of which maybe following different methodologies and collate them together to get context-specific information ... and be able to take appropriate action at the right time. There is a gap between what management wants to communicate and how its information system is geared for gathering and distributing the information. Current reporting formats provide too little and too late for investors to rely on them to be able to take accurate action.

Here is where enabling technologies help to provide companies with an easier means to communicate information and deliver it to investors in a format, which lends itself to easy analysis. In today's networked, technology-intensive world, very few lives are untouched by the power of Internet.

Internet, as we know, is a global network of a network of computers that use a common language to transmit and share data and applications. Originally started for military use in the 1960s, its capabilities have exploded into commercial and everyday lives of people all over the world.

Most companies use the internet to publish their annual reports and other information like career opportunities or as an advertisement tool, the purpose being to achieve faster, controlled, accurate and more reliable information exchange. However, most information that appears on company websites are usually just a transcript of paper-based reports—even if they are made more appealing with graphs, charts and the like. While Internet increases speed of transmission, it does not automatically make information any easier to extract or use. Stacks of electronic mail have replaced stacks of paper—users still need to take printouts of reports for analysis, which really does not make working any less opaque.

Information provided by companies on the internet is usually 'dead'—not only because information is historical in nature (reporting on events that

have already occurred) but more importantly because such information does not allow analysis or application to specific user requirements. Reusing such data almost always requires manual transcription to another software environment that the user may be employing with inevitable breakdown of data integrity.

To overcome all these barriers, companies need to speak a common electronic language—a reporting language that combines the power of Internet and also transmits information to users with enhanced capability to analyse data.

A non-profit consortium of over 250 major companies, organizations and government agencies, has developed a new language for electronic communication of business and financial data. This is called eXtensible Business Reporting Language – XBRL, for short—which is the business reporting branch of XML, which stands for Extensible Markup Language. XML is considered to be the next big step in Internet technology after HTML- Hypertext Markup Language.

XML provides context for every piece of information so that a user can understand exactly what it represents and also how to use it—the definitions are at a much more fundamental, ‘molecular’ level. This allows users to seamlessly access information and is fast becoming a universal language for e-business.

XBRL web services help free ‘dead’ information by representing it digitally. Digital information then moves freely and independently since it is not embedded in a paper-based format. When information is web-enabled, it becomes vibrant and ‘living’, lending itself to easy analysis. Information is suddenly available to a global audience in a far more efficient manner than just as a block of text appearing on a web site.

XBRL enables companies to create diverse internal and external reports in moments and offer information in a format that enables recipients across the corporate reporting supply chain to instantly access and re-use company information with their own web services enabled analytical tools.

XBRL is just one of the enabling technologies being developed and tested, although it is one of the more popular ones. Of course, even the success of such a powerful medium is totally dependent on the integrity of the base data. That is, XBRL is only as good as the quality of information that is tagged and transmitted. Data efficiency and accuracy is subject to its own set of standards.

Focus on Corporate Misstatements and Fraud

Corporate fraud is more prevalent than most people imagine or are willing to admit. While high profile fraud involving misstatements and other gross financial irregularities create sensational news, in reality, corporate fraud goes on at a deeper level throughout the company—and on a regular basis.

It is important that auditors and regulators alike catch small, seemingly insignificant irregularities early on so that these do not balloon into large-scale fraud that hurt every constituent of the capital market.

It is the primary duty of directors and managers to run a clean ship. Top management is always responsible for defining corporate culture and it is naive to think that senior managers do not collude or have no clue about active fraud perpetrated by the company.

In 1996, the CEO of Unison Healthcare (now Raintree Healthcare Corporation) handed the company comptroller a piece of paper and said “...here’s the numbers we need to get to” and “I don’t care how we get there”. The comptroller, company, CEO and CFO had to face SEC charges and penalties. (Source: Commissioner Isaac C.Hunt at “SEC Speaks 2000”, Washington, March 2000)

Auditors and accountants, in turn, were under tremendous pressure to make sure that reported numbers add up to publicly committed numbers. This was the basic reason for ethical breaches. As time goes on, such breaches become habit; creating a vicious circle where no one is sure any more of what ‘real’ numbers look like.

There are no guarantees that deliberate efforts by management to mislead investors and regulators will not occur—or that an auditor will be able to detect and report such management efforts. A major reason why auditors do not detect fraud is that not all fraud is reflected in financial statements. These may be in the form of bribes, conflict of interest, product piracy, industrial espionage, etc. The dangerous bit about these frauds is that they usually involve large sums of money and active participation of top management—and do not leave a visible audit trail.

Bloodhounds, then?

Clearly, fraud is firmly in focus and prevention is no longer discretionary. It appears that auditors are being called upon to be more of bloodhounds than mere watchdogs, as has been the accepted wisdom.

Many of the suggested procedures in regulations of countries like US and EU are forensic in nature. These involve performing substantive tests or

applying methods and techniques of evidence collection, which presume the possibility of dishonesty at various levels of management.

But being a forensic accountant is more than a simple matter of buying some software and hardware. What is critical is that the investigator must understand where and how to look for the relevant trail and more importantly, what to make of it.

Perhaps two reasons hold back an auditor from aggressively tackling the possibility of fraud:

- Passivity—hoping it will go away or remain unnoticed by regulators
- Arrogance—fraud happens to other people.

The rationale behind the insistence on fraud detection is that successful crimes lead to more crimes and the most effective way to deter fraud is to severely punish the ones that come to light.

Auditors are now required to approach each audit with professional skepticism and not take for granted or assume that management is honest. In a departure from accepted audit norms, new standards require auditors to test areas, locations or accounts that may be considered low-risk, in an unpredictable manner and at times that are unexpected by the client.

Fraud, or economic crime, is sometimes called a 'victimless crime'. However, as John Wilkinson and David Baral of PricewaterhouseCoopers say, companies that fall victim to such crime often suffer damage that is more severe than direct financial loss. So fraud must be treated on a par with other crimes.

They argue that fraud places at risk a company's crucial intangible assets—its brand value, public image carefully nurtured over many years and even its intellectual capital—who wants to be associated with a fraudulent company—or other business relationships. The collateral damage from fraud equals or is greater than the financial loss the company may face.

But however sophisticated a company's fraud risk management systems may be, it is human instincts and judgment that forms the first line of defense in the battle against fraud. And that is why many good companies institute strong whistle blowing procedures.

Non-GAAP Financial Information

Investors, regulators and other users need reliable information in a language they understand and in a format that they can use easily. The common language of financial reporting that companies and users of information speak is called GAAP- generally accepted accounting practices.

Then there is a set of information that does not conform to GAAP, popularly known as non-GAAP financial information. Non-GAAP financial information refers to any numerical information that omits anything a comparable GAAP would require or that contains anything that GAAP would exclude. Such information is also called 'pro-forma' (as if) reporting. Pro-forma earnings are reported differently from GAAP earnings. Companies use this form of reporting to exclude certain special or one-time expenses or incomes so that regular operating profits can be reported. These unusual items tend to skew results between periods and so its effect is disclosed separately.

Pro-forma earnings statements are used to increase transparency regarding unusual items, for example, income tax or other legal settlements, gains/losses on sale of assets or business units or any other one-time transaction that is not expected to recur or that does not have a bearing on regular operating results. If the effect of such unusual items cannot be isolated and separately reported, it would make it more difficult to get a true picture of the company's performance.

Companies find that the following non-GAAP financial information provides investors with a clearer picture of its performance:

- EBITDA: Earnings Before Interest Tax Depreciation and Amortization
- Cash flow
- Revenue excluding impact of one-time transactions
- Operating profit excluding the effect of acquisitions

Trouble begins when managers use the pro-forma route to 'manage' earnings to avoid a blood bath at the stock markets if earnings estimates are not met by actual performance. A company that selectively applies the pro-forma rule to 'smoothen' earnings over different periods tends to 'cloud' rather than highlight the true financial position. Non-GAAP or pro-forma information is useful and appropriate as long as a tenable link, both in value and time, can be established and honored. Abuse of this system arises because reporting pro-forma information is not

standardized. By its very nature such information cannot be compared across different periods or different units within the same company and worse, across different companies.

United States is one of the first countries where regulators have stepped in to put a sense of order into this practice. US also has a very strong capital market and issues of regulated pro-forma reporting, following closely on the heels of high profile corporate financial scandals are clearly very important to address.

Non-Financial Data As A Measure of Performance

In a traditional information system, focus is on tangible assets and liabilities like plant & machinery, financial instruments, etc and accounting standards that are used deal mainly with solid, tangible subjects. But financial objectives alone tend to be rather one-sided and do not provide a realistic assessment of the business. There are many non-financial objectives that are equally important in achieving profitability.

Financial performance measures are of little relevance in predicting a company's future financial performance. The financial model of measuring performance is increasingly unsuited to modern businesses, particularly those in the so-called 'new economy'. Intangible assets like brand value, knowledge base, networked relationships, etc are crucial elements of success in modern businesses. It is the strength and value of intangible assets that marks out the difference between competitors.

For instance, if a company spends money on building up a brand image of its product or even its entity, the traditional reporting model would require expenditure to be charged either in one year or at best spread over a short period of time. However, the enduring benefits of such an exercise usually extend up to many years, sometimes even increasing in value as years go by. Such benefits, translated into tangible things like customer loyalty and hence increased sales are substantial—and very difficult to quantify.

Kodak, the giant photograph company, conducts annual photo sessions in certain play schools of New Delhi. It then develops large, beautifully mounted individual and group photographs and sells them at a reasonable price. The whole exercise may not produce a lot of revenue for the company—it may just about recover direct costs. But it is brilliant as a long-term strategy of creating a future customer base. It is hard to imagine these kids buying any photograph product other than Kodak as adults.

If the benefits of such an idea can be captured and reported in forward-looking statements with any degree of accuracy, it would provide the missing link between activities undertaken presently and its expected financial results. In fact, such intangible assets can provide a better indicator of future financial performance.

These are also the most difficult to measure and that is what makes it very challenging to use as a strategy.

There are a great many measures of evaluating non-financial data that are available. Companies need to be careful about adopting an evaluation method that is based on too many measurement indices because that can only degenerate into an exercise without conclusive results.

- The 1st step towards adopting a formal system of non-financial measurement is to identify the key value drivers of the company. This will necessarily be a long drawn-out process and is the most crucial step.
- The 2nd step is to establish links between key value drivers and action plans. That is, to identify cause and effect relationships between drivers and outcomes.
- The 3rd step is to focus on things that matter. There are many data or actions that display cause and effect relationships; companies should focus only on data that is as relevant to the bottom line as is possible to estimate.
- And last but a very important step is that once a measurement process is established, it will need constant updating at each link of the chain. What is a key driver today may well shift focus six months later as the environment changes

To get an idea of how difficult it is to quantify valuations of intangible assets, consider this: as per current accounting standards, intangible assets are recognized only if it is separately acquired or as a part of an integral unit. But in the modern economy, the very definition of an asset may have to change. Wharton accounting professor, Chris Ittner says, ‘the standard definition (of an asset) is that it is an item in which a company has a legal right or interest. But that concept (of an asset) gets fuzzy when you talk about something that walk out of the door, like knowledge or customers... what happens when a company invests in customer satisfaction? Management may expect a return on its investment, but it is not something that the enterprise owns.’

Non-financial performance measurement system needs to be based on better and more sophisticated qualitative and quantitative methods. One that can deliver non-financial information that is believable, appropriate

and meaningful and is supported with suitable evidence—just as with traditional financial figures. It can be an additional framework over existing processes. It fills in the gap left by financial reporting and delivers a robust measurement mix to complete the overview of performance. Investors look to non-financial methods to *supplement* and not *supplant* traditional financial indicators.

The real benefit of integration is not just as an accounting and reporting instrument but as a tool for managing the drivers of value.

How Much To Report?

Everyone agrees that information is the lifeline of capital markets. Companies are faced with a dilemma of where to draw the line between information overload that may be counter productive and even spark off a panic reaction or underreporting which may land them in trouble with various interest groups.

New technology and the power of Internet have made it possible to make available information on an unprecedented scale. Even a simple Internet search on any company or topic would reveal tens and hundreds of pages. But a closer look will show that that such information hardly speaks in one voice—indeed, because of the staggeringly huge quantity, the information-to-noise ration actually declines.

Disclosure, Again Disclosure & Still More Disclosure

Disclosure—voluntary or compulsory—is meant to arm investors with knowledge required to make an informed decision, the belief being that a thus empowered investor can protect himself from corporate abuses and/or mismanagement. Most regulation is guided by the assumption that more information is better than less. Also, most regulation is aimed at making companies disclose more information. How this information is going to be used by investors, analysts, regulators themselves, etc., is often overlooked.

It is a paradox that people can become overloaded with information and actually make worse decisions with more information. The human brain can process only a limited amount of information. Once the information level reaches a certain point, however, the decision-maker's decision quality decreases if she is given additional information. The idea is that at some point people become overloaded with information and make worse decisions with more of it.

Most people also lack the training (maybe even intelligence) to comprehend and assimilate information contained in balance sheets, profit and loss accounts, advisories, etc. that a company puts out periodically. Regulation, then, can provide information largely for the sake of information.

Once the information level reaches a certain point, however, the decision-maker's decision quality decreases if she is given additional information.

The Middle Ground

How much information should companies give? The straightforward answer is to avoid the extremes—that is not to give too much or too little. The tricky bit lies in knowing how much is enough.

It is rather simplistic to assume that all information is reflected in stock prices or that all information is correctly interpreted. It is useful to have a clear idea on who the user of information is. Users may include large institutional investors, small individual investors, bankers, regulators, analysts and even business rivals. Each of these users has different abilities, requirements and may use different strategies. So different users use the same information differently. It is hard for companies to decide what to disclose and what to hold back.

- *One option* is for companies to disclose specific information to specific users, say analysts, who possess a high degree of sophistication and analytical tools and whose opinion other users can trust.
- A *second option* is for companies to provide information for the 'average' user—one that falls in the median of the cluster of users. Such information may serve a good general purpose and serve a large proportion of users.
- A *third option* is to have a 'layered' disclosure system where different sets of information are provided to different levels of users. While this option will provide more insightful information, delivered to the right targets, it increases the cost of collection for the company.

In the final analysis, information should act like a clean pane of glass in a shop front—you don't notice the glass, but you can clearly see what is displayed inside.

Kshama V. Kaushik
Kaushik Dutta

Kshama V. Kaushik and Kaushik Dutta are chartered accountants.