

ViewPoint

Jan 05

Corporate Reporting

No more fixes –
time for
fundamental
revision*

Most people are familiar with IT systems. When first implemented, IT systems are full of promise. They are designed to address the needs of a business in an exact and comprehensive way. Ideally, they are integrated and logically structured. The people who work with them come to know them inside and out, and such systems often put operations on an entirely new basis.

But businesses change, and systems must change with them. Businesses increase in size and complexity. They acquire new objectives and shed old ones, gain new stakeholders, enter new markets and territories, merge with other businesses. Their information needs change. All the time the IT environment is changing; new technologies appear that can make existing systems look antique.

What happens then? Again, the picture is familiar. The IT team often attacks one problem after another in a piecemeal way. In the rush to improve the situation, they may patch in new modules that solve one difficulty while creating others. The system is often so inflexible in its basic design that these cumulative, improvised changes can gradually reduce control and security. Users sometimes create their own systems to manage information that the main system can no longer manage. The overall result is what IT professionals call a *kluge* – a system that lacks relevance, stability, security and, in some cases, integrity. What's the solution?

It's time for a new system

In our view, this is the current state of the corporate reporting model. It is breaking down and needs to be rebuilt. Years ago, when business was different, the corporate reporting model still in use today met the needs of most stakeholders. But two things have happened since then.

First, business and finance have changed in magnitude and become much more complex, with greater vulnerability than ever to external events in all parts of the world. In response to the global magnitude of business and vastly greater complexity, too many patches have been applied – and continue to be applied – to the old system. Differing patches are applied by national regulators to address specific needs, typically with the care we expect from authoritative accounting and regulatory bodies, but in some cases the patches fail to address important issues. Even when successful, the sheer volume of patches has made the system unwieldy.

Second, information needs are changing. Corporations are providing a huge volume of information at considerable cost (including the cost of assurance), solely to meet the needs of regulators. Yet the increasingly voracious, and legitimate, information demands of today's investors and other stakeholders are not being adequately met. Much of the information they receive today strikes them as irrelevant, and much that they want and

deserve has no place in the current reporting model. They go in search of the information they need from other sources. Today's questions are not satisfied by yesterday's answers.

There are strengths in the old system. They must be retained. But there are also weaknesses, excess, and gaps. Those problems must be remedied. Today's corporate reporting model is breaking down. Tomorrow's corporate reporting model is urgently needed.

What are the problems with the existing model?

The current model fails to make visible some of the most basic building blocks of a company's financial performance. It fails to communicate key contextual and non-financial information and metrics by which management actually make key decisions, set strategy, and assess performance. It fails to meet the verifiable, stated information needs and expectations of experienced investors and their advisers. And it has become so complex, owing to successive layers of regulation and standards, that even the CEO can look with perplexity at the company's own financial statements, discussion and analysis, and annotation. In some countries and in some circumstances it doesn't prevent games of hide-and-seek that comply with the letter of regulation while defeating its intention, which is to achieve clear and complete disclosures of all relevant information.

The results of a recent PwC survey¹ of 43 investment professionals in the UK – typically heads of research in large investment management institutions and investment banks – offer one body of evidence for these observations. With remarkable consistency, the participants agreed that the current reporting model fails to meet some of their basic requirements for transparently presented, complete information. They pointed to serious shortcomings in the presentation and completeness of data on liabilities, capital, the sources and sustainability of growth, costs, and risk. With regard to risk, they frequently mentioned the need for an analysis of the sensitivity of returns to changes in key variable factors of production – interest rates, foreign exchange rates, commodity prices, wage rates, and so on.

Further PwC research², industry-specific in scope, has focused on determining what information is of particular value in managing an entity (i.e., management's view) and in assessing an entity for investment purposes (i.e., the investor's view). In the course of that research, several thousand investors, analysts, and business executives offered the view that the current reporting model lacks valuable contextual and non-financial metrics. Of particular interest among the research findings was the relative importance the respondents attached to contextual and non-financial information. Across 16 industries, more than 75 percent of the measures that management and investors ranked as important were contextual and non-financial.

Who has a stake in better corporate reporting?

First of all, senior corporate executives and boards of directors, who are ultimately responsible and accountable for the reports issued by their companies. They want to issue high-quality information in order to allow investors to fairly evaluate their businesses. They have no appetite for assembling and publicly disclosing information that today's stakeholders regard as irrelevant. Then investors, who rely on corporate information to make sound investment decisions. Also deeply involved are members of our own profession, accountants and auditors, who should be intellectually confident in the standards governing their work. They have every right to feel that those standards are a close approximation of the state of the art, and every right to feel that their work is highly relevant and highly valued by the capital markets. All of these stakeholders, together with standard setters, analysts,

corporate information packagers, and information technology experts, are key participants in the capital markets.

Two facts emerge:

- The current corporate reporting model satisfies few unbiased, experienced preparers and users of corporate information.
- All stakeholders in the capital markets have a vested interest in an effective corporate reporting model.

¹ 'Outdated accounts', European Business Forum, August 2004

² 'Trends 2005: Good Practices in Corporate Reporting', PricewaterhouseCoopers, December 2004

Pressure for
change is building;
the existing model
is continuously
being patched
and has become
unstable and
unwieldy

Four fundamentals of the new model

It would be presumptuous to set out on our own to draft a new corporate reporting model. We are a committed participant in the capital markets with clients in virtually every industry and nearly every country, and working relationships with regulators worldwide. For this reason, we are acutely aware of the differing perspectives of other participants, and we believe that only sustained cooperative effort will achieve a shared view. In addition, our familiarity with the perspectives of corporate leaders, boards of directors, accounting and auditing authorities, analysts, regulators, and sophisticated investors permits us to suggest in broad terms the characteristics of a new model.

We believe that a fully adequate corporate reporting model will have four fundamental characteristics:

1. **Conservation of existing strengths.**

Any valid new corporate reporting model will retain the strengths of the current model, which represents – with all its faults – the knowledge and experience of generations of participants in the capital markets. What are those strengths? Some of them are evident in point 4, but few are agreed globally or by all stakeholders. Each will require attention and debate.

2. **Clarity.** The new model must be clear. In some respects, this may require simplification, while in other respects the direction will be toward clear presentation of complex matters. In all instances, unnecessarily complex accounting and reporting can be stripped away. The unsatisfied but legitimate concerns of users of corporate information, specifically with regard to cash-flow reporting and the factors and trends likely to underpin future performance, will need to be satisfied.

3. **Principles-based.** A new corporate reporting model will need to be principles-based, rather than rules-based, and the principles should be agreed globally by all stakeholders. Existing frameworks, such as IFRS, could be used as a starting point. However, the principles adopted should not be limited to the preparation and presentation of financial information. The new principles will surely need to address the broader profile provided collectively by financial statements and key contextual and non-financial information, with some elements conveyed in quantitative terms (metrics) and other elements in careful narratives. A new set of principles is likely to build on established assumptions for financial reporting, such as the “going concern” concept, but also on qualitative characteristics such as “reliability”. There may well be principles relating to the presentation of information “through the eyes of management”.

There is a dilemma in the balance between principles and rules. Principles applied properly cement judgement and integrity into the reporting model. They are effective when preparers and their assurance providers exercise appropriate judgement with regard to economic substance. However, principles can lose their effectiveness when and if rules define a multitude of circumstances that might occur in the absence of appropriate judgement. Under the rules-constrained scenario, compliance with rules substitutes for the exercise of judgement as to correct and incorrect, right and wrong. In jurisdictions where principles rather than rules are the primary guidance, principles properly applied prove to be more rigorous than rules and provide a basis for clarity of reporting.

4. **Suitable scope.** A new corporate reporting model will include a clarified and in part simplified financial reporting model. As the basis for a broadly informative corporate report, rather than a narrowly focused financial report, it will also include new categories of information, especially contextual and non-financial information relevant to understanding current

performance and future prospects. There is much work to be done to examine and define the specifics for each item of information in a valid new corporate reporting model. These issues among others need to be addressed:

- **Items of information.** While the financial statements will need review and clarification, constructive revision should not be limited to the financial statements. What other areas need to be addressed by a fully adequate corporate reporting model? Here again the issue of contextual and non-financial information crops up – for example, as to the objectives and strategy of the company, brand development, and human resources.
- **Risk.** As part of a review and revision of the principles governing the recognition of transactions in financial statements, attention should be given to the measurement and formal recognition of risks, presumably in the narrative section of a new corporate reporting model.
- **Measurement.** This concern again encompasses both the financial statements and information conveyed outside of the financial statements. Historically the focus has been on measurement within the financial statements; however, similar issues arise relating to information conveyed outside of the financial statements. Should narrative reporting be supported by quantitative measures? What measures and what types of information might be provided for each key performance variable?
- **Presentation.** In the interest of clarity, the form of presentation of both the financial statements and contextual and non-financial information should be carefully reformulated.

More than 75%
of measures
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There are four
key tenets to be
considered by
participants:

- conservation of
existing strengths
- clarity
- principles-based
- suitable scope

Pressure for change is building

As suggested by the IT system analogy, the existing corporate reporting model is becoming unstable and increasingly lacks relevance to today's business information needs. Change is clearly a high priority. But action will be required from all stakeholders in the capital markets. If revision of the corporate reporting model is left entirely to the initiative of legislators, regulators, and standard-setting bodies, the business and financial communities cannot realistically expect a new reporting model that reflects their particular concerns. They must counterbalance their resistance to change with the need for an improved fundamental model. Today's patched system, too complex in some dimensions and unresponsive to legitimate needs, must be rebuilt.

No single stakeholder can be expected to carry the entire responsibility. Further, no single stakeholder can realistically be expected to take the holistic view that will only emerge from collaboration and consensus-building.

Authoritative bodies are working in their own domains to develop elements of a new model. The Management Discussion and Analysis (MD&A) in the US, the new requirements for the Operating and Financial Review (OFR) in the UK, and King II in South Africa come to mind. The commitment of the European Union to have all listed companies report according to International Financial Reporting Standards (IFRS) and the "Norwalk Agreement" to work toward convergence between IFRS and US Generally Accepted Accounting Principles (GAAP) should also be cited as important efforts. Something resembling Global GAAP is on its way. However, will the integration of two "systems" that are already heavily patched and fundamentally different – one rules-based, the other principles-based – add up to an improved reporting model? Only if a collaborative approach is adopted can this be successful.

Investors, their advisers, and other users of corporate information will continue to press for a fuller, more satisfactory portfolio of

information. This need is balanced by the threat to their competitive advantage in assembling information to fill the gaps, but without participation key information may remain beyond their grasp.

It is no wonder that some companies, and perhaps most, prefer to react to these issues rather than enter proactively into shared efforts to improve the corporate reporting model. They are under pressures of all kinds. Yet in our view they have an invaluable and distinctive role to play. It is no longer sensible for businesses simply to comply with the corporate reporting model without also sharing thoughts about what should be disclosed to shareholders and other stakeholders. A revised corporate reporting model would permit businesses to make their cases more effectively. In robust companies, strengths would be more evident if contextual and non-financial information were a consistent part of the model. And in companies struggling with problems, a fuller view of those problems and their possible solutions could encourage investor patience and loyalty. Business has much to gain by getting involved.

Technology experts are making a tremendous contribution through the development of the Extensible Business Reporting Language (XBRL), which will enable cost-effective reporting of a broad information set. Using this new technology, companies will be better able to assemble, format, and communicate their information. Investors and their advisers will be better able to format corporate information to suit their analytical purposes. And there is a trend among regulators to support the use of XBRL. We must not be constrained by older, familiar technologies; we must exploit the opportunities available through technological advances.

Attestors of corporate information can do no better than the model that itemises and structures the information. PricewaterhouseCoopers will not be shy about offering new and fundamental ideas for change, beneficial to all stakeholders, which can feed into a revised and much more informative corporate reporting model.

Organising new forums

We are confident that there is more than enough intellectual capital and willingness among all stakeholders in the capital markets to organise new forums in which the many issues requiring discussion can be raised and brought to consensus. Realistically speaking, recommendations from such new forums will not have binding power. The authoritative bodies will still need to examine independently, selectively adopt, and bring them into effect. But from our point of view, the next step toward the new model for corporate reporting is collaboration among all stakeholders. We should all view the rebuilding of the corporate reporting model as an urgent priority, and take action now.

The new corporate reporting model will be owned by all stakeholders and relevant to all. And this is as it should be.

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