The Future of Financial Reporting: A Market Perspective

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INTRODUCTION

Investors and other stakeholders are looking for transparency beyond the basic financial statements to better understand how businesses operate and perform.

Following on the heels of corporate scandals at Enron, WorldCom, Parmalat, Livedoor, and others internationally, investors around the world are demanding stricter corporate governance and compliance requirements for publicly held companies. Not only are reporting requirements increasing to meet this demand, but accounting standards are changing as well. Investors are looking for transparency beyond the basic economics to better understand how businesses operate and perform.

Finance and accounting executives around the globe face the pressure of understanding, adapting to, and managing the costs associated with these changes. For those that prevail, there is an opportunity to leverage this shift to better position their companies in the eyes of the investment community. To succeed you must have an awareness of the issues and embrace the new principles and technologies underlying these new requirements.

IMPROVING AND GOING BEYOND THE FINANCIAL STATEMENTS

Investor backlash has resulted in new regulatory requirements designed to restore the public trust, including the Sarbanes-Oxley Act (SOX) in the United States, the European Union Accounts Modernization Directive, reforms of capital markets in South America, and the recent approval of J-SOX—the Japanese version of Sarbanes-Oxley. In addition to demanding better internal controls and corporate governance practices, investors and other stakeholders such as customers, partners, employees, and communities are demanding more disclosures to improve transparency into the inner workings of companies and the impacts on the environments in which they operate. Reporting of income statements, balance sheets, and cash flows is no longer sufficient—stakeholders are demanding disclosures related to executive compensation, energy usage, environmental issues, hiring and labor practices, charitable programs, and other social issues.

Due to the increased level of stakeholder interest in corporate governance as well as the emergence of pension and mutual funds that focus on socially responsible companies, a number of new indices are emerging to rate the corporate governance and performance of public companies and their longer-term viability or

sustainability. For instance, the Standard & Poor's Corporate Governance Scores[1] and FTSE ISS Corporate Governance Indices[2] focus on equity structure, board independence, integrity of the audit process, executive compensation, and stock ownership, in addition to financial results. The Dow Jones Sustainability Indexes[3] and Ethibel Sustainability Indices[4] rate companies based on economic, environmental, and social criteria.

So what near-term changes do finance executives in publicly traded companies need to know about, and what does the future of financial reporting look like?

Changing and Converging Accounting Standards

Nearly 100 countries currently require or permit the use of, or have a policy of convergence with IFRS.
Source: *Business Finance* magazine (March 2006)

One of the key areas of change that finance executives need to be aware of relates to global accounting standards. In March 2006, *Business Finance* magazine[5] reported that nearly 100 countries have adopted or permitted the use of the International Financial Reporting Standards (IFRS) generated by the International Accounting Standards Board (IASB). From its base in London, the IASB is quickly completing its mandate to develop a single set of global standards that require transparent and comparable information in general-purpose financial statements.

Momentum Behind the Global Adoption of IFRS

In 2005, all European Union countries, South Africa, and Australia adopted IFRS. In January of that same year, the IASB and the Accounting Standards Board of Japan announced their agreement to launch a joint project to reduce differences between IFRS and Japanese standards. Canada has pledged that standards for public companies will converge with IFRS over a five-year transitional period. In the United States, the Financial Accounting Standards Board (FASB) is working with the IASB to merge U.S. accounting standards with IFRS.

China's plan to substantially adopt international accounting standards should offer investors more information about the actual value of companies listed on that country's stock exchanges. Starting in 2007, companies listed on the Shanghai and Shenzhen exchanges will be required to largely adopt IFRS for financial reports.

This convergence of global accounting and reporting standards represents good news for investors, because more-consistent financial reporting standards make comparisons of global companies and assessments of investment opportunities much easier. However, these changes can make life more complex for finance executives, who need to be aware of the coming changes, the impact on their financial results and the ability to raise capital. They also need to know which accounting standards were used to prepare the financials of other companies they are working with or considering as partners.

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[1] Standard & Poor's Corporate Governance Scores: www2.standardandpoors.com/spf/pdf/products/cgscriteria.pdf
[2] FTSE ISS Corporate Governance Indices: www.issproxy.com/institutional/cgi/index.jsp
[3] Dow Jones Sustainability Indexes: www.sustainability-indexes.com
[4] Ethibel Sustainability Indexes: www.ethibel.org/subs_e/4_index/main.html
[5] Fay Hansen, "Global Accounting Comes of Age," *Business Finance* (March 2006).

Migration from Rules-Based to Principles-Based Standards

The shift from rules-based standards to the principles-based approach puts more focus on improving transparency versus simply complying with standards.

Finance executives in countries where IFRS is mandated should already be familiar with the standard, as should those at U.S. subsidiaries of European and other firms, because they need to report results to their parent companies under the IFRS guidelines. Those not familiar with IFRS will find that the shift from rules-based U.S. standards to the principles-based approach of IFRS puts more focus on improving transparency versus simply complying with standards. However, there are many challenges ahead for the FASB and finance executives of U.S. public companies who will be making the transition to IFRS.

Proponents of the change to a principles-based approach argue that the current volume of new accounting standards, regulations, and opinions is creating an overly complex and unworkable system. Opponents claim that a system based on vague principles that are open to interpretation could leave more room for error, corruption and shareholder lawsuits. Core to the IFRS approach is the concept of *fair value* accounting, where assets and liabilities are marked to market value rather than maintained at historical costs.

Although this approach provides users of financial statements a clearer picture of the economic state of a company, it gives finance executives less control over revenues and expenses, and could end the practice of "earnings management." This makes finance executives uneasy.

Fair value accounting should not be entirely unfamiliar to U.S. finance executives, because current FASB accounting rules for such items as derivatives, securitizations, and employee stock option grants already use this approach. However, valuing assets and liabilities in the absence of active markets could be very subjective and make financial statements less reliable. Nevertheless, the FASB is moving forward to adopt this concept in specific areas—with pension and lease accounting proposals currently up for discussion. For the convergence process to succeed, the FASB will need to provide implementation guidance to support the shift to principles-based accounting, and finance executives will need to provide training programs for their staff on interpreting and implementing new principles.

Additional Disclosures

Along with the changes in accounting and reporting standards, finance executives must also respond to demands for increased disclosures of both financial and nonfinancial metrics. Many companies have already been impacted by the changes in accounting and disclosures related to stock options and executive compensation. In fact, a growing number of companies around the world are beginning to disclose metrics related to the longer-term "sustainability" of their businesses.

Increased Use of Sustainability Indicators

Many EU countries have recently enacted legislation that mandates some form of sustainability reporting. Some countries require environmental disclosures and some require environmental and social reporting, but the trend is definitely moving toward greater adoption of these reporting requirements across Europe. As mentioned earlier, analysts tracking public companies have begun to include

sustainability factors in their recommendations to investors, and banks have begun factoring sustainability into commercial loan assessments.

In addition to the mandatory reporting of sustainability indicators, many companies are disclosing this information on a voluntary basis. Major corporations including GE, Motorola, Intel, Wal-Mart, Citigroup, Polaroid, Target, Toyota, Ford, and GM are increasingly aware of the positive brand impact of being perceived as environmentally and socially responsible. Any company that operates in an environmentally exposed industry (for example, chemicals, pharmaceuticals, resource extraction, and power generation) and in a socially exposed industry (for example, diversity issues, working conditions, workforce retirement, and reduction) should consider sustainability reporting as a way to convey a positive public image and promote its responsibility as a corporate citizen.

One organization is emerging as the standards body for sustainability accounting and reporting practices—the Global Reporting Initiative. The majority of organizations that publish a sustainability report make use of the GRI system of social, economic, and environmental accounts and metrics.

Although this type of reporting might sound complex and open to inconsistencies, one organization is emerging as the standards body for sustainability accounting and reporting practices—the Global Reporting Initiative (GRI).[6] The majority of organizations that publish a sustainability report make use of the GRI system of social, economic, and environmental accounts and metrics. GRI is an offshoot of the United Nations Environment Program, intended to develop sustainability indicators for the private sector. The number of companies that reported using the GRI standard has grown from nearly 500 worldwide at the start of 2005 to 1,100 by the middle of 2006.[7]

New Business Performance Reporting Initiatives

In addition to demand for more-detailed financial disclosures, and environmental and social metrics, investors are also requiring more-detailed disclosures on other industry and company-specific performance metrics. This concept is being promoted by the Enhanced Business Reporting Consortium (EBRC).[8] Driven by the AICPA Center for Public Company Audit Firms and cofounded with Grant Thornton LLP, Microsoft, and PricewaterhouseCoopers, this consortium of stakeholders is collaborating to improve the quality, integrity, and transparency of information used for decision-making in a cost-effective, time-efficient manner.

The EBRC released its framework for enhanced business reporting in 2005, providing a disclosure guideline to help companies better communicate with their investors and other key audiences about business strategy and current and expected performance. This framework includes guidelines for disclosures regarding business landscape, strategy, competencies and resources, as well as business performance.

With investors demanding all of this additional information, how are finance executives supposed to create, manage, and deliver these reports and metrics? And how can the investors access and leverage this information?

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[6] Global Reporting Initiative: www.globalreporting.org
[7] Number of companies in the GRI Register publishing reports as of October 2006: www.globalreporting.org/reportsdatabase/searchthedatabase
[8] Enhanced Business Reporting Consortium: www.ebr360.org

Electronic Delivery and Access: XBRL the Emerging Standard

XBRL was designed to streamline the preparation, analysis, and communication of business information. It offers cost savings, greater efficiency, and improved accuracy and reliability to all those involved in supplying or using financial data.

While the Web has been helpful as an information-sharing vehicle for publishing and accessing financial reports and disclosures, an electronic publishing standard is emerging. Extensible Business Reporting Language (XBRL)[9] was developed by a consortium of companies as an Extensible Markup Language (XML) standard designed to streamline the preparation, analysis, and communication of business information. It offers cost savings, greater efficiency, and improved accuracy and reliability to all those involved in supplying or using financial data.

Since its introduction, XBRL has been adopted by a number of regulatory bodies around the world, and taxonomies have been developed for U.S. generally accepted accounting principles (GAAP), Canada GAAP, UK GAAP, IFRS, China-listed companies, and others. XBRL is now being piloted by the U.S. Securities and Exchange Commission as an alternative to the Electronic Data Gathering, Analysis, and Retrieval (or EDGAR) filing process, and SEC Chairman Cox has been promoting the benefits of XBRL. We could soon see a move beyond the pilot phase for companies listed on U.S. exchanges. An XBRL taxonomy for the GRI sustainability reporting standard is also under development, so this approach could be viable for both financial and nonfinancial reporting.

THE FUTURE IS NOW

What does the future of financial reporting look like? The answer is that pieces of the future are here now—increased regulatory compliance requirements, global accounting standards, more disclosures, as well as streamlined communication of financial results.

The good news is that the regulators and financial markets in general have stepped up to respond to investor demands for improved corporate governance, compliance, and transparency. The bad news is that the more-stringent regulatory requirements, along with the demand for improved disclosures, is driving up the costs of being a public company. For example, according to a 2005 Financial Executives International[10] report, external audit fees for 217 companies surveyed increased an average of 58 percent, while fees for external consultants, software, and other vendors increased 66 percent due to year-one Sarbanes-Oxley compliance activities.

Best Practices for Staying Ahead of the Curve

How can finance executives stay informed and reduce their compliance costs for new requirements? Here are some of the best practices adopted by leading firms:

- **Keep abreast of the activities of accounting standards bodies.** Gain early access to proposals and provide feedback so you can influence these activities. Model the impacts of pending accounting changes on your company's financial statements and plan for the transition.

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[9] XBRL International: www.xbrl.org
[10] Financial Executives International press release, "Sarbanes-Oxley Compliance Costs Exceed Estimates": fei.mediaroom.com/index.php?s=press_releases&item=47

- **Consider the positive impacts of voluntarily publishing a sustainability report.** If your company is not required to report environmental and social metrics, start the process of collecting and publishing this information. Companies that proactively publish this information spend less time reacting to ad hoc requests for sustainability information, receive higher corporate governance and sustainability index ratings, and can attract more capital.
- **Align data collection and consolidation processes.** Many companies have separate processes for the collection of financial results, operating results, and sustainability information, while market leading companies are aligning these processes. The result is more control and consistency over financial and non-financial reporting, improved data integrity and audit trails, as well as savings in time, effort, and costs.
- **Reduce the reliance on spreadsheets.** Start by adopting enterprise performance management (EPM) software to support the collection, consolidation, and reporting of financial and non-financial information. Spreadsheet-based reporting processes lack control, are prone to errors, and don't provide adequate audit trails. The consolidation modules of today's EPM software suites typically support multiple accounting standards (U.S.-GAAP, IFRS, and so forth), provide validations and controls over the process, and can handle the collection of both financial and nonfinancial metrics, including sustainability metrics.
- **Become familiar with XBRL.** If you are not already using XBRL, learn more and start preparing yourself for the possibility of this standard becoming mandatory. Join the SEC voluntary filing program to experience the benefits of XBRL. There are a number of XBRL tagging tools available on the market and some of the reporting tools of EPM suites, such as Oracle Hyperion Financial Reporting offer support for XBRL.

CONCLUSION

The demand for improved corporate transparency is driving the shift to global accounting and reporting standards, additional disclosures around areas such as environmental or social responsibility and the adoption of XBRL for electronic publishing of financial results. Executives who stay ahead of the curve and are educated about current trends have the best chance for reducing their costs of adopting these new requirements.

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