Recasting the reporting model

How to simplify and enhance communications

Opportunities for discussion

2008

PricewaterhouseCoopers

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Further insights

You can also join the debate via David Phillip's Corporate Reporting blog, where your comments are welcomed: http://pwc.blogs.com/corporatereporting/

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Contents

Our research

Throughout the paper we draw on research we have conducted with members of the corporate sector and the investment community. Our findings have given us insights into the needs and opinions of these key players within the capital market system. We have also recently completed desk-top research of the primary regulatory filings of the companies within the FT Global 500, the second year we have reviewed the reporting of the world's largest companies.

We have used some of this analysis to bring the reporting model issues alive and to help identify some opportunities to be considered in recasting that model. We recognise that communication channels other than annual reports and Form 10-Ks are used by companies to disseminate information and by investors to receive it. However, in our research we have focused on the snapshot of today's corporate reporting provided by these primary, and arguably most important, records of material information disseminated to the market over a reporting cycle.

Foreword

An agenda for a new reporting blueprint

> 'Recasting the reporting model will not be achieved by prescriptive regulation'

The time has come for a new, market-driven blueprint for corporate reporting to be developed to reflect shortcomings in the current model and the growing challenge of climate change. This discussion paper aims to explain how this can be achieved and the building blocks that need to form part of the solution. It draws on our research with global investment communities as well as the world's largest companies. The paper is not intended to provide an exhaustive list of the issues that need consideration, but to act as a catalyst for collaboration, new thinking and a fresh approach from all participants in the corporate reporting process.

Objective and relevant information on corporate activity is essential to sustain and grow healthy capital markets and the societies in which they operate. As society's expectations increase around the environmental, social and governance responsibilities of the corporate community, companies are under an increasing obligation to provide clearer information on a wider range of business activities. But today's corporate reporting is failing to adequately support these aims: it is too financially orientated, too technically complex and, critically, it ignores key elements of business performance including sustainability issues (carbon emissions, water and resource usage). These elements must rapidly become a central part of the model if companies, investors and governments are to make the right capital and resource allocation decisions over the next few decades.

Successful companies recognise that transparency is a critical element of what's expected – a part of their 'licence to operate'. However, the current reporting landscape has evolved in a piecemeal way and does not provide a logical, cohesive or efficient framework for communication that is essential today. Currently, companies' reporting is dominated by financial outputs and is too often seen as purely regulatory compliance. While some companies use it effectively to communicate all corporate activity, the majority fall short on the explanation of strategy, the drivers of value and the key performance indicators (KPIs) critical to understanding business success.

PricewaterhouseCoopers believes the time has come for policymakers to facilitate the collaborative creation of a new market-driven blueprint for reporting, one that harnesses market forces and so stimulates a healthy and vibrant business environment. Recasting the reporting model will not be achieved by prescriptive regulation, which could diminish its value as a catalyst for change. However, a blueprint for a more holistic corporate reporting framework could facilitate a 'lighter touch' by governments and reduce the need for prescriptive regulation by leveraging the natural checks and balances that exist in a transparent market – such as interventions by stakeholders, public interest organisations and the media.

As a first step in realising this opportunity, a new set of parameters for high-quality corporate reporting needs to be established to underpin the breadth and nature of the information that needs reporting. These should principally comprise:

- A user-centric focus to ensure the provision of relevant and reliable information.
- Principles-based reporting to reduce the risk of boilerplate compliance.
- External reporting that flows from internal management information, expressed in plain language so that it is easy to prepare, understand and access.
- Integration of financial, contextual and non-financial information so that investors have the complete information set needed to make informed decisions.

This discussion paper highlights some opportunities and issues that all interested parties need to debate in establishing the parameters of a new reporting blueprint. As these are explored, it is important to recognise that a number of market-driven initiatives already exist that are working towards solutions in particular areas of measurement and reporting. These include the Connected Reporting Framework developed by the Prince of Wales as part of his Accounting for Sustainability project. This framework provides a vision of how the model can be recast to embrace environmental and social issues. The World Intellectual Capital Institute has also developed a high-level corporate reporting framework and is using a Wikipedia-style internet platform to facilitate collaboration across interested market organisations (see page 36).

The second critical step is to recast the current financial reporting model to reduce its complexity. To achieve this, the relative value of information, the costs of preparation and the demands of stakeholders all need to be considered. This may prove difficult, but we believe it is fundamental to the success of reframing the whole model.

While this paper does not seek to specifically address reducing financial reporting complexity, we are greatly encouraged by the actions of several stakeholders in the reporting process who are already developing proposals for how to simplify and enhance current financial reporting in a way that is complementary to opportunities highlighted in this paper. These actions include the recommendations of the US Securities and Exchange Commission's (SEC) Advisory Committee on Improvements to Financial Reporting (see Appendix 2, page 32), to which PricewaterhouseCoopers has contributed, and reports issued by the CEOs of the largest international audit firms around principles-based accounting standards (see Appendix 4, page 35). There is also renewed focus at the International Accounting Standards Board (IASB) on its management commentary project and several user forums have been created to increase investor and corporate involvement in developing the reporting model.

We believe that it is in the interests of policy makers, standard setters and key stakeholders to engage in a market-driven initiative to create a global blueprint for improved corporate reporting. However, given the growing recognition of the challenges facing the world around climate change, we believe real urgency needs to be brought to this issue and that it should be a public policy priority. The starting point is for all stakeholders to come together and debate the issues and opportunities set out in this paper and ensure that market mechanisms are harnessed to continually build value. The prize will be enhanced yet simplified reporting, more effective and efficient capital markets and a major contribution to creating a more sustainable world.

Samuel A DiPiazza Jr.
CEO
PricewaterhouseCoopers International

'The prize will be enhanced yet simplified reporting, more effective and efficient capital markets, and a major contribution to creating a more sustainable world'

Recasting the reporting model
Elements to factor into a new blueprint

To enable a global initiative for improved reporting to take off, the views of capital market participants need to be heard

As policy makers, standard setters and others develop a market-driven initiative to create a global blueprint for improved corporate reporting, the views of capital market participants are critical to the debate. Over the last decade PricewaterhouseCoopers' extensive research programme has identified a number of core elements that warrant particular emphasis in the context of the parameters set out on the previous page.

Explaining value creation

The financial reporting model remains the bedrock for all company analysis. However, financial data isn't the only kind of information that investors and companies need. Through PricewaterhouseCoopers' research of management and investors' views, we know that both groups see a broad information set as critical to understanding business performance. This includes information about the market context in which a company operates, management's strategic aims and the key drivers of value. The broader information set also covers the key performance indicators associated with those drivers along with key risks.

The reporting of such issues has received relatively little time and attention from regulators, even though it is essential in understanding performance. Assurance of the information is generally only asked for at specific times, such as when a company first raises capital from the market. There also appears to be a lack of clarity around where responsibility lies for the establishment and maintenance of reporting frameworks covering such information. Furthermore, some frameworks that do exist for this broader information set are rules-based rather than principles-based, which some argue has led to excessive and impenetrable disclosures, with little information value.

The upshot is that information about how companies create value in existing models is of variable quality, with perceived management bias and inadequate oversight, particularly within existing regulatory reporting models.

Building an effective information bridge

Ideally, the reporting model should be a bridge between the internal management information used by companies and the valuation process undertaken by investors. However, our research provides evidence that this bridge, as currently structured, is weak and incomplete.

Some companies provide insufficient strategic information on the direction of travel and medium-term goals, or lack granularity on performance data (whether financial or non-financial). Currently, few mechanisms exist to highlight what's important to management, information that can assist the market to differentiate good management from the lucky.

In recasting the reporting model, the emphasis therefore needs to be on opportunities for both enhancement and simplification: enhancement to ensure the right information is reported to enable understanding of corporate performance; and simplification to ensure investors can access and understand information easily and companies can efficiently prepare and disseminate it across multiple reporting channels.

Here, technologies that enable improved accessibility and use of data, for example eXtensible Business Reporting Language (XBRL), have an important part to play. The initial focus though should be on determining the right information set – one that is logical, comprehensive and cohesive, and fully explains the critical elements of the value creation process, not just the financial outputs. By creating the full information framework for business reporting first, the development of the taxonomy for smart electronic tagging of information can be approached in a more effective way and so deliver better insight to users.

Streamlining existing processes

As a new corporate reporting model is developed, participants in this collaborative effort should consider whether streamlining current processes could improve the cost/benefit ratios companies achieve through all their reporting, while at the same time enhancing the scope, quality and cohesion of information being made available to the investment community. Perhaps the regulatory reporting model should be seen as a succinct summary of all the material information made available to the market over the cycle, whether currently within or outside the scope of current regulatory models.

Regulatory filings such as annual reports and Form 10-Ks currently suffer from a lack of timeliness, often emerging after the annual results have been initially reported to the market. This aspect of the current model introduces inefficiencies and risks into the reporting process that could possibly be removed by rethinking how and when information is made available to the market.

Both companies and investors accept there is a problem and have developed numerous workarounds to the current regulatory reporting process. For example, as well as formal reporting to the market, companies also engage with investors through presentations and conferences, during which management takes pains to communicate the information it sees as most important. As one would expect, the information is both strategic and operationally focused. Much financial information is presented at these events using non-GAAP measures or formats, as companies explain underlying performance, cash flow and prospects.

Improving the efficiency and alignment of these processes and the delivery of equivalent information to all interested parties on a timely basis should be key elements in the development of a new corporate reporting model.

A more progressive financial model

In the current model, the majority of effort by companies and attention from standard setters and regulators is focused on financial information. This is understandable. As business has become more complex, so has the complexity and volume of financial reporting.

However, continued effort devoted narrowly to the existing financial reporting model may result in diminishing returns. Could more be done to explain variations in reported performance that occur from the application of different judgements, for example in areas such as provisioning, obsolescence and fair value?

Can better disclosures inform where measurement systems, at times, fail? In the world of intangible assets, for example, it is less important for investors to be given a value for a brand than for them to see how the value is determined or how that brand contributes to value creation within the broader business context.

Companies and investors have become frustrated by regulatory models that do not encourage the right focus in critical areas, such as growth, costs, segment details and assumptions that underlie key figures. There is also a lack of forward-looking orientation – meaningful discussion about the sensitivity of financial performance to key external trends and factors is not commonplace.

Making sustainability mainstream

As society's awareness of the importance of sustainability (particularly climate change) has increased, so the challenge of clear and effective sustainability reporting has moved up the agendas of public bodies and companies. This challenge must be addressed in the blueprint for a new reporting model.

If reporting is to reflect fully the developments and requirements of the sustainability agenda, it is critical that the interdependent relationship between existing financial data and other data (including social, customer, supplier and environmental indicators) is made clear. In particular, the measurement of carbon must be an integral part of this model, and there is growing evidence to suggest we have limited time to address this issue. Connecting the various elements of reporting in this way could have a transformational impact on reporting by ensuring that companies' decision-making and strategy and investors' valuations are based firmly on a more complete picture of performance.

Developing a broad corporate reporting model that enables a balanced understanding of an organisation's total impact or 'footprint' appears to be of growing relevance and should not be ignored as we reframe the model.

Taking the debate forward

We believe these elements should all be considered as interested parties debate recasting the current reporting model. Particular attention needs to be paid to the relative value of information, the costs of preparation, workarounds, and the needs of investors and other stakeholders. Potential solutions could result in some elements of current complexity being removed. Others could result in enhancements, to ensure that relevant information is provided in an accessible way.

This discussion paper seeks to take forward the debate about how the reporting model could be optimised. Given the significant challenges facing all societies around sustainable wealth creation, climate change and the use of scarce resources such as water and energy – and the influence which the corporate sector exerts on them – it is becoming increasingly urgent that the reporting model effectively communicates this.

Developing a game plan
Understanding today's information flows

The investment community currently receives information from many disparate sources – these flows need to be understood before a new model can be developed

> 'Repetition, reformatting and workarounds are commonplace'

A clear understanding of the overall shape of the information flows to the investment community will allow opportunities to simplify and enhance the current corporate reporting model. Development can then focus on both the information set to be reported and on streamlining the processes of information preparation and distribution.

Set out opposite is a diagram that provides a simple picture of the main mechanisms used by investors to obtain information on the companies about which they are making capital allocation decisions.

Institutional investors receive information directly from companies in the form of annual, quarterly/interim and preliminary regulatory filings and reports, as well as required stock exchange announcements and press releases. Companies also report a significant amount of information to the market through analyst presentations, either undertaken at the time of the regulatory result releases or as part of ad hoc engagement exercises, such as conferences and business visits.

Some of this information repeats data included in the regulatory filings, albeit in a different format and often adjusted from GAAP. However, these alternative channels of communication are typically used to provide investors with supplementary information giving more insight into the business.

This might include for example:

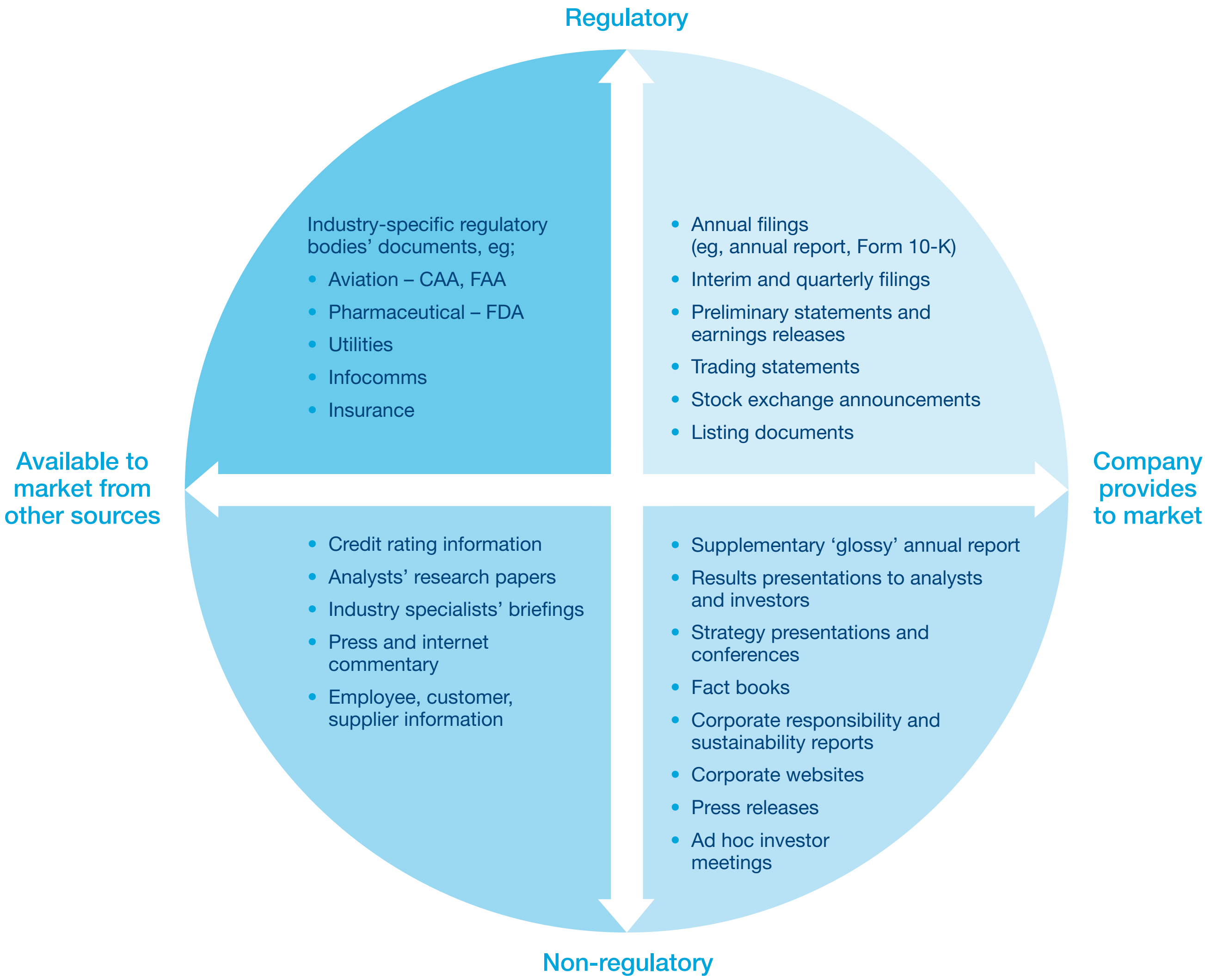
- Management's view of the market in which it is operating
- Details of the strategies it is implementing to compete in those markets
- Factors that may have an impact on short-term performance and risk assessments
- Management's view of the underlying financial and operating performance

Increasingly, corporate responsibility and sustainability reports are used by companies to communicate information on these aspects of their business. Again, some information from regulatory reporting may well be repeated in these reports, but they also contain a myriad of data not covered in the current regulatory frameworks, as do corporate websites.

Investors also receive information from sources outside companies, for example from analysts' research papers and from credit ratings agencies who provide detailed debt information that companies themselves are not supplying. Further information flows, less formal in nature, also reach investors via press and other media commentary, as well as through channels such as employees, customers and suppliers.

The disparate nature of these information flows – in which repetition, reformatting and workarounds are commonplace – contributes to some of the inefficiencies and duplication of effort we see in the corporate reporting model today.

Figure 1: Examples of today's information flows to the investment community

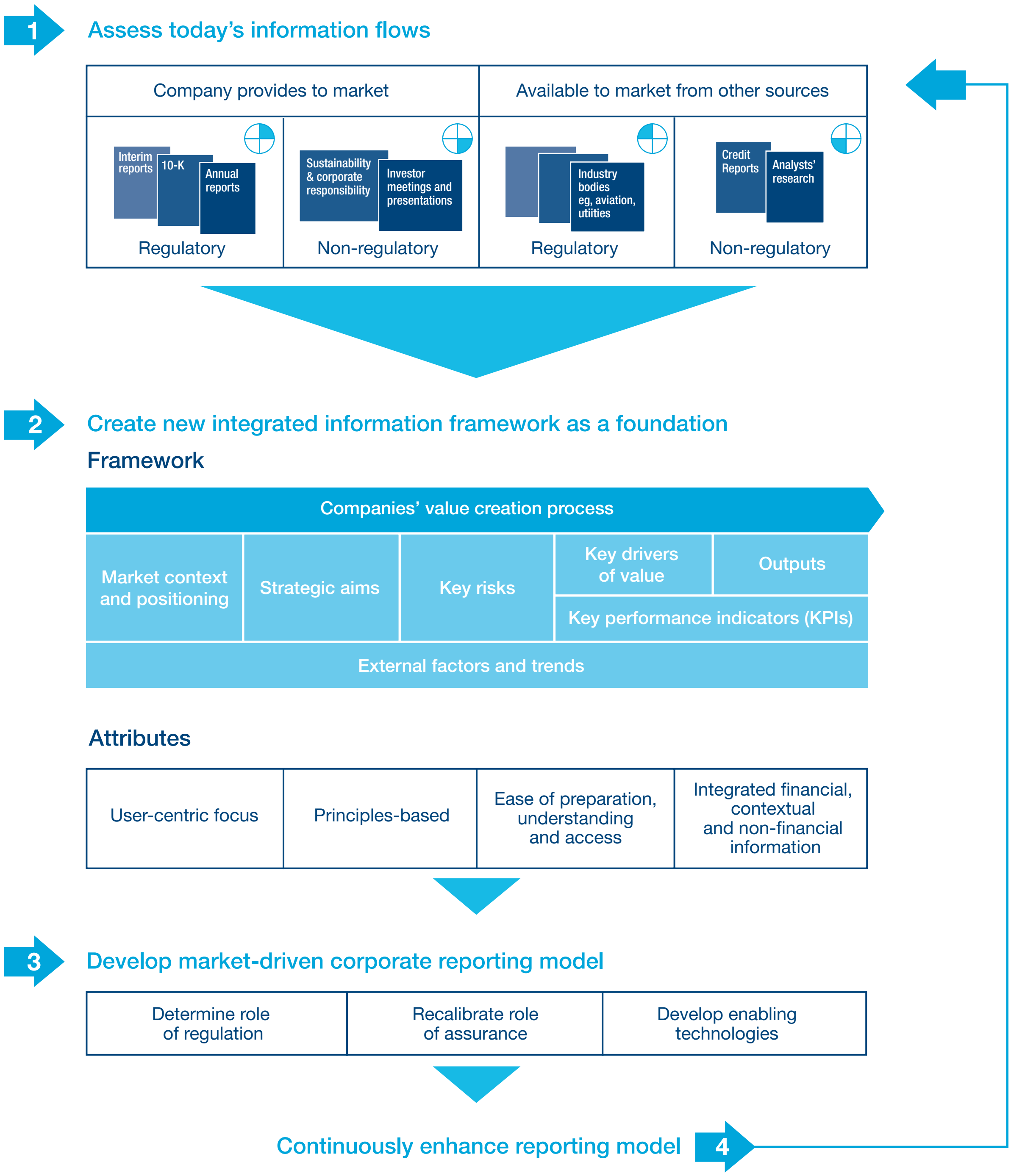


Developing a game plan

Towards a new corporate reporting model

Efforts to recast the corporate reporting model need to be collaborative and streamline preparation of information and its distribution

Figure 2: Developing a new corporate reporting model



The diagram in figure 2 sets out four steps at the heart of developing a new corporate reporting model.

1 Assess today's information flows

Taking a good look at today's information flows gives stakeholders the opportunity to assess the potential for improving the efficiency and effectiveness of the communication process. There may be opportunities, for example, to reduce duplication of effort, and to address issues such as the timeliness of information.

2 Create new integrated information framework as a foundation

Through the research we have conducted over the past decade, we have begun to create an integrated information framework that redefines the broad scope of information that needs to be communicated between companies and investors. The suggested framework and nature of the information address the core elements we believe need to be factored into developing a new corporate reporting model, namely:

- Embracing the way companies create value
- Providing an effective bridge from management reporting
- Creating an efficient and effective communication process
- Including a more progressive financial model
- Accommodating sustainability reporting

The framework brings together GAAP, non-GAAP and narrative reporting and can help companies structure the depth of information needed to facilitate real understanding of business performance.

Over the years, a number of companies have adopted similar frameworks in their reporting. Recent regulatory framework proposals have also drawn on this research. However further collaboration is required to seize the opportunity to build out and validate this framework with the active participation of all key constituents in the reporting process.

We believe this collaborative effort will only occur if leading policy makers around the globe recognise the importance of this issue and facilitate bringing market participants together. In this regard, they are the individuals who have the position and the power to provide leadership, challenge the inevitable friction in the system and help ensure the initiative gains traction.

3 Develop market-driven corporate reporting model

The next step in the collaborative process is the development of a new corporate reporting model using an agreed integrated information framework as the foundation.

To ensure the new model and its processes are efficient and effective, the extent and nature of the regulatory overlay required must be determined, along with the potential to recalibrate the role of third party assurance for the broader information set. Furthermore, the agreed corporate reporting framework model would provide the logical structure for the development of an XBRL taxonomy, one which enables more effective business reporting.

4 Continuously enhance reporting model

To ensure that the corporate reporting model and information flows continue to meet stakeholders' needs, the collaborative process must be continuous. As businesses become ever more sophisticated and new reporting challenges are faced, there will be opportunity to continually reassess the flows of information and consistency across communication channels. Ensuring that the integrated information framework and related taxonomies remain relevant must be part of the continuous enhancement of reporting.

To help develop the game plan further, the final part of this discussion paper sets out some of the opportunities for stakeholders to consider as they come together to develop a new corporate reporting model. These opportunities are based on aspects of reporting across the information framework observed in our research into the current model.

We are not prescribing specific solutions for any one participant in the process to implement. Taking some of the opportunities presented may be straightforward, while others may need more long-term effort. All are worth considering as participants in the capital markets collaborate in developing a new corporate reporting model.

'The process must be collaborative from beginning to end'

Opportunities to address reporting issues
Summary of the options

To bring the recasting process to life and to take it to a more granular level, we highlight opportunities to address reporting issues as an integrated information framework is created

‘Our aim in presenting these opportunities is to stimulate debate and drive forward the process of developing a new corporate reporting model’

Here we consider elements of current reporting observed during our research and the opportunities to address some of the issues as stakeholders come together to create an integrated information framework and debate the attributes of that information. The opportunities we focus on, which are more fully explained opposite and are linked to the outline framework in the previous section, are:

- Contextual information.
- Insights into performance and prospects (eg, risks, KPIs, and impact of external trends and factors).
- Reporting different levels of information – the importance of understanding the ‘information hierarchy’ particularly where financial information is concerned (eg, segment information, underlying operating performance, and debt disclosures).

For each of these aspects we outline:

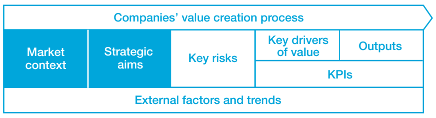
1. The findings of our research into the information reported today by the world’s largest companies in their regulatory filings.
2. How valuable the investment community currently finds this information, based on our research, and what other sources of supplementary data it values.
3. The opportunities we believe arise for stakeholders, as they create an integrated information framework, to collaborate on addressing issues identified by the research.

We recognise that communication channels other than annual reports and Form 10-Ks are used by companies to disseminate information and by investors to receive it. However, in our research we have focused on the snapshot of today’s corporate reporting provided by these primary, and arguably most important, documents of record, which should contain all information that is material over the reporting cycle. It is therefore interesting to note that the current level of content and the focus of these reports vary considerably, depending on the regulatory jurisdiction.

We believe the opportunities presented will lead to information with a user-centric focus that is principles-based and easy to prepare, and which is understandable and accessible for both companies and investors. Our suggestions also bring together financial, contextual and non-financial information – a critical aspect of creating an integrated information framework. Our aim in presenting these opportunities is to stimulate debate and drive forward the process of developing a new corporate reporting model.

Some companies are already grasping these opportunities and setting an example for effective communication. To see a selection of extracts from company reports, from across the world and many different industries, visit the Good Practice section of www.corporatereporting.com

Contextual information

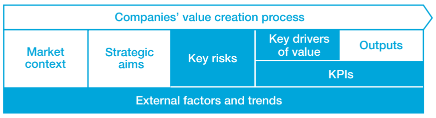


By contextual information we mean an overview of the market environment in which the company operates and its strategic objectives. This provides critical information for stakeholders on the front end of companies' value creation process.

As stakeholders come together to create an integrated information framework, the opportunity exists to reduce the persistent gap between the effort and time companies dedicate to reporting contextual information (often duplicated and augmented outside regulatory reporting), and the perceived limited value of that reporting for investors.

Light touch, principles-based regulation can add value by reducing the focus on pure compliance and prescriptive requirements that often lead to excessive standardised disclosures and little differentiation between one company and another.

Insights into performance and prospects



An enhanced picture of past and future performance can be gained from fully integrating the following elements into the information framework.

Risks

Capital markets are driven by the returns investors expect to achieve for assuming different levels of risk. There is an opportunity to clarify reporting of principle risks and how they are managed. As new risks become more prominent in the assessment of investment opportunities – for example risks associated with carbon, water and resource usage – so the information framework must flex to accommodate the changing risk environment.

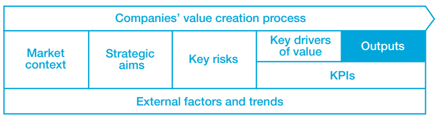
KPIs

The ongoing development of mechanisms for multi-stakeholder collaboration to define industry-specific KPIs is a key part of creating the information framework. Successful examples already exist and have resulted in companies reporting consistent KPIs that they know are of most value to investors and other stakeholders. In the natural resources industry, for example, measures for proven and probable reserves have been developed.

Impact of external trends and factors

Third party information on external trends and factors is often referred to by investors – industry regulatory bodies, for example, provide consolidated data on key industry trends. In creating the integrated information framework, stakeholders have the opportunity to ensure that management's own insight into those trends and factors, and quantification of them, is visible to all stakeholders.

Reporting different levels of information



As the integrated information framework is created, different degrees of detail and a variety of information links can be included to enhance the explanation of performance and to streamline the flows of data between companies and investors. We focus on some opportunities to address these issues within financial reporting. It is critical that all the ideas currently being considered by regulators and standard setters from these initiatives are brought together to create one integrated information framework.

Segment information

Granular segment information is core to management reporting and highly valued by investors. Consistency of information across the different communication channels can enhance the efficiency and effectiveness of segment reporting, reducing 're-work' for both companies and investors.

Underlying operating performance

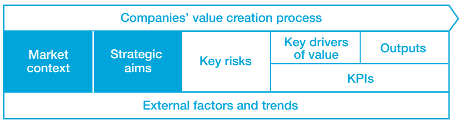
There are opportunities in creating the integrated information framework to make certain information mainstream that will allow underlying operating performance to be distinguished. This includes information about the impact of acquisitions and disposals, non-GAAP disclosures together with non-recurring and exceptional items.

Debt disclosures

Information that is relevant to a full understanding of a company's debt position and management's funding strategies should be factored into the work to create the new integrated information framework. This should focus on disclosure as well as measurement of debt. Debt investors have a particular role to play here.

Opportunities to address reporting issues
Contextual information

Companies devote significant space in their regulatory reports to narrative information – is it fully effective in communicating a holistic view of the business, including its markets, goals, performance and prospects?



Contextual information, which is often non-financial, forms part of companies' broad narrative reporting, together with information on risk, corporate governance and executive remuneration, among other things.

Contextual information, when reported alongside the financial statements and other elements of an integrated information framework, helps investors to gain a broader understanding of a company's business, markets, strategic aims, performance and future prospects.

Information on a company's businesses and markets, for example, could include the competitive, regulatory and macro-economic trends and factors that shape it – both historic and forward-looking – supported by quantified evidence. Information on the company's strategy could include its goals (both overall and by segment), how it plans to achieve them, and an assessment of progress against those targets.

Reporting in regulatory filings

Companies allocate a high proportion of space in their regulatory reports to broad narrative reporting. As illustrated in figure 3, the majority of the 483 Financial Times (FT) Global 500 companies we were able to survey – 70% – devote more than 60% of their annual regulatory report to narrative reporting.

Figure 3: Proportion of report that is not financial statements

Narrative reporting is a high proportion of overall report

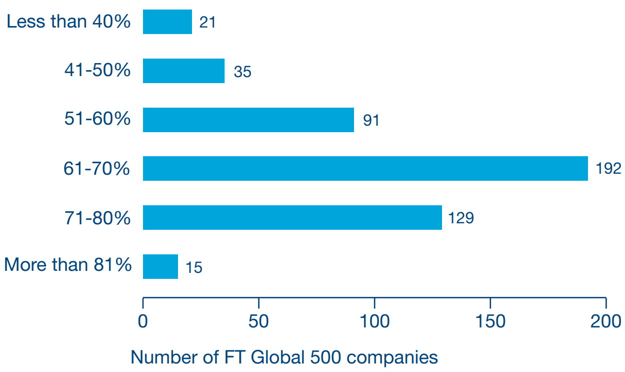


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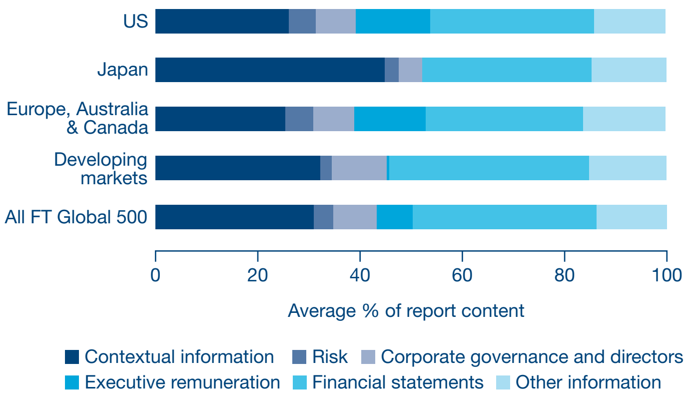
Figure 4: Average report content proportions by region

Companies in US, Europe, Australia & Canada devote similar proportions of their reports to the same categories of information. There are marked differences observed in Japan and in the developing markets.



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As shown in figure 4, the proportion of pages within that narrative reporting devoted to broad contextual information varies depending on jurisdiction.

There are regional variations too in the type of information reported in contextual data, for example for market information as shown in figure 5. This is a reflection of regulatory requirements and investor demand. For example, US companies are strongly influenced by their regulatory regime, following the specified content requirements for narrative information in a Form 10-K, such as competitive conditions, seasonality and backlog orders. Regulatory frameworks are less specific in other regions and this is reflected in the broader nature of the information reported by companies there.

Strategy can be viewed as the backbone of a company's reporting. Overall objectives and strategies are commonly reported (85% and 77% respectively). Just over one third of the companies explain their segments' strategies with a similar proportion reporting future targets within their strategy discussions. Using design techniques to 'signpost' strategic information is evident in 54% of the companies. Again, there are wide regional differences in reporting of strategic information and targets – see figure 6.

Figure 5: Types of market information by region

US companies tend to follow prescribed 'categories' of market information

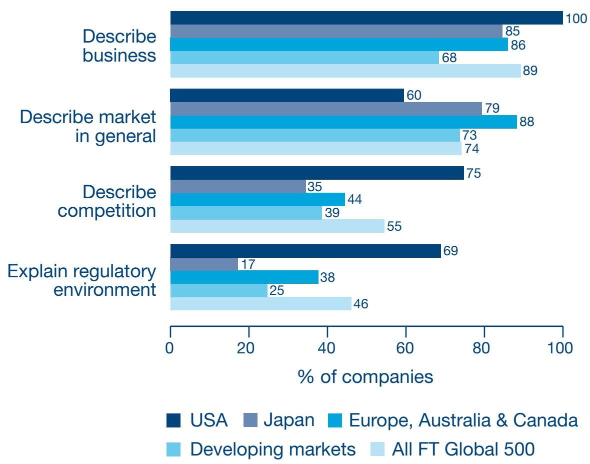

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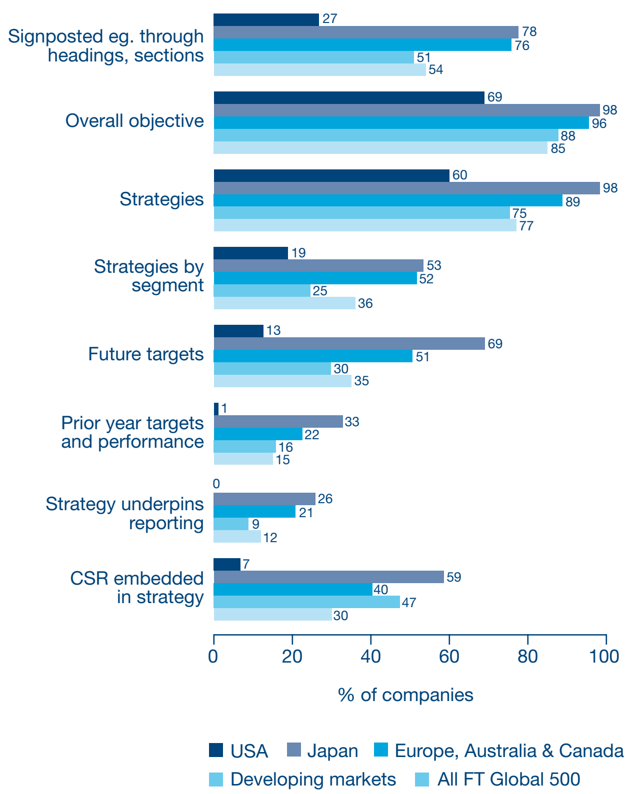
Figure 6: Types of strategic information by region

Strategy reporting is most comprehensive in Japan. US 10-Ks rarely include detailed strategic information



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Value for investment communities

Information that provides some context for financial reporting is highly valued by investors. However, the contextual data presented in regulatory reports often lacks timeliness and is perceived to lack objectivity; there are large gaps between the investment community's view of the importance of such data, and its view of the adequacy of the information. As shown in figure 7, the gaps are particularly significant in relation to information on markets and strategy.

Given these gaps between the perceived importance and adequacy of the contextual data provided in regulatory reports, what do investors and analysts do? Our surveys show that they turn to other sources, including investor briefings by management, objective market reports and information provided by companies' competitors.

As they turn to these other sources (those perceived to be more timely or with less PR spin), so the gaps between importance and adequacy reduce somewhat – see figure 8.

Figure 7: Investors' view of the importance vs the adequacy of contextual data in the **annual report/10-K**

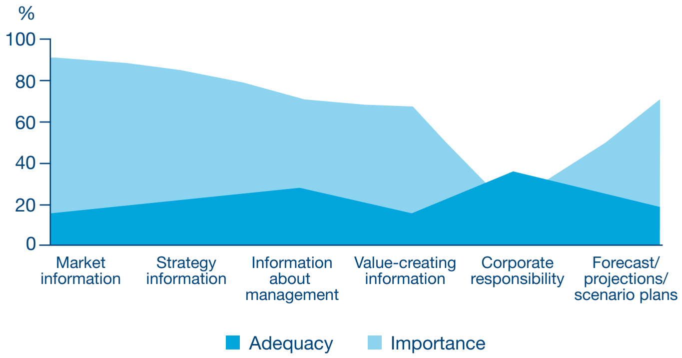

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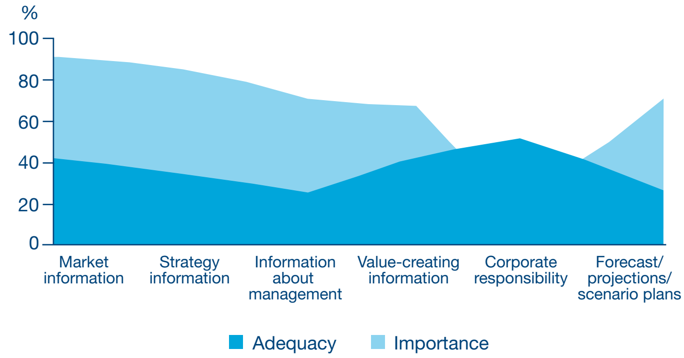
Figure 8: Investors' view of the importance vs the adequacy of contextual data from **all sources**



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Opportunities

As stakeholders come together to create an integrated information framework, the opportunity exists to reduce the persistent gap between the effort and time that companies dedicate to reporting contextual information and the perceived limited value of that reporting for investors.

This opportunity to enhance and simplify reporting on contextual information can be realised through stakeholders coming together to identify exactly what the market wants. But within the resulting information framework companies must also be able to report what they believe is useful and important. This does not mean giving away trade secrets, but rather providing investors with sufficient information to enable an informed assessment of the context of a company's performance.

Stakeholders can also assess whether light touch, principles-based regulation can add value by reducing the focus on pure compliance and prescriptive requirements that often lead to excessive standardised disclosures and little differentiation of one company from another. Another consideration is whether appropriate liability protection could enable companies to provide more forward-looking information that would help the market to develop more insightful scenarios about future performance.

Market participants may also want to explore whether rebalancing external assurance to focus more on contextual information will add value and help to minimise the perception of management bias.

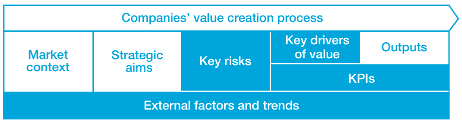
The efficiency and effectiveness of today's communications can be reassessed as the information framework evolves. If regulatory reporting is to be a summary of all material contextual information put into the market over the reporting period – a document of record for all stakeholders – the consistency of that information will be enhanced by connecting all communications from that period across the different dissemination channels.

'The opportunity to enhance and simplify reporting on contextual information can be realised through stakeholders coming together to identify exactly what the market wants'

Opportunities to address reporting issues

Insights into performance and prospects

Insight into past performance and future prospects is critical for investors' decision-making – appropriate reporting of risks, KPIs and external trends makes a difference



Indicators of past performance and future prospects include information on the risks that a company faces, key drivers of value and associated KPIs, together with analyses of external factors and trends that have in the past had, and could in the future have, an effect on business activities. These elements of the information framework are important to the investment community because they allow companies to be compared within industry sectors. They also give analysts and investors better insight into how past performance has been achieved and the likelihood of meeting future performance targets.

Risks

Risk is a critical component of the integrated information framework that enables understanding of past performance and future prospects. This area includes the identification of the key risks that have had an impact on a company's performance, or may influence its future prospects. Risk information also includes explanation of how these key risks are managed and mitigated.

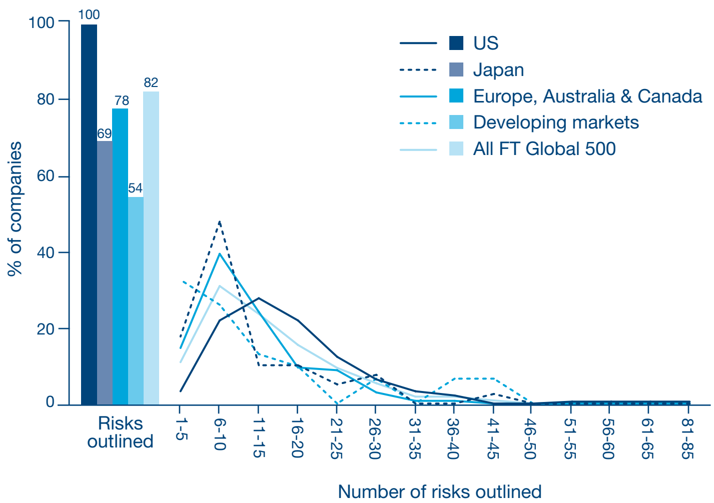
Reporting in regulatory filings

Over 80% of FT Global 500 companies outline their risks. However, just 16% clearly identify those risks that are key to the business. Where risks are outlined, the average number is 14, though the highest number of risks identified is 82. The maximum number of key risks identified is 24, with the average being seven.

There are regional differences in risk reporting. Companies in the US are most likely to report their risks and to have the highest reported number of risks – but they are least likely to identify which of those risks are key. Companies in rapidly developing capital markets are least likely to report on risks – see figure 9. Of the 62 companies in the FT Global 500 that identify key risks, 35% quantify these risks and around three-quarters (76%) explain how they are managed or mitigated.

Figure 9: Company reporting on risk: proportion of companies reporting on risks and the number of risks reported

Developing markets are the least likely to report risks. US companies outline more risks than other regions.



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Line chart base: number of companies outlining risks in each region

Value for investment communities

Investors believe the current reporting models provide insufficient visibility of the financial and operational risk assumed by companies, which inhibits their ability to assess future financial and business prospects. Arguably, this is one of the most important aspects of reporting – business is all about taking risks. Investors can struggle to see the wood for the trees in some jurisdictions where management's position is protected by reporting large numbers of risks. In other regulatory frameworks, investors are provided with little or no risk information. In either case, it is harder to identify any critical symptoms or early warnings of potential effects on the sustainability of performance and value – arguably as seen in the credit crunch of 2007/2008.

Value is added for investors where business risks (at both the macro and micro level, individually and collectively) and the mechanisms used for mitigating them are clearly reported. Extending this to incorporate sensitivity analysis on key assumptions made in determining those risks can further enhance that reporting.

> 'Creating a flexible framework can accommodate changing risks and minimise excessive non-differentiating risk disclosures'

Opportunities

Capital markets are driven by the returns investors expect to achieve for assuming different levels of risk. Without the understanding that clear risk reporting can provide, investors have to make assumptions about risks. The greater their uncertainty, the greater the returns they are likely to demand for taking those risks.

As a relevant integrated information framework is developed, there is an opportunity to provide clarity around identifying and reporting company-specific principal risks and how they are managed. As new risks become more prominent in the assessment of investment opportunities – for example risks associated with carbon, water and the use of resources – so must an integrated information framework be flexible enough to accommodate this changing risk environment, without leading to excessive risk disclosures that do not differentiate one company from another.

Companies already manage and mitigate their business risks in various ways, from controls to training. Now there is an opportunity to work with others to establish how best to communicate these activities to the market. Explanations of mitigation processes, together with sensitivity analyses of potential outcomes, can also enhance investor confidence in management.

Key performance indicators

Including KPIs in the integrated information framework enables assessment of company strategies and their potential for success. KPIs can be measures defined under GAAP or they may be non-GAAP metrics. KPIs linked to strategic objectives can include financial measures of success, such as return on capital employed, EBITDA and cash conversion. They can also include operational measures, such as staff or customer turnover, product penetration and so on.

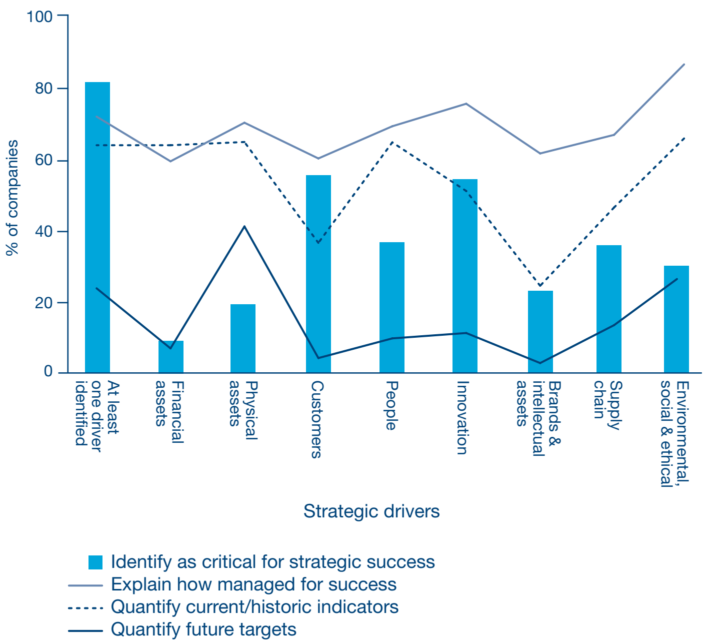
Reporting in regulatory filings

Increasing numbers of companies are reporting KPIs in their regulatory filings – either voluntarily or due to regulatory requirements. Twice as many (nearly 30%) did so in 2006 compared to the year before. This trend to report measures of success is evident in all industry groups, and is particularly noticeable in Europe, Australia and Canada where nearly 50% of the companies surveyed now report KPIs. Most of the KPIs reported relate to financial measures of success (82%) rather than operating measures. In the UK, where reporting KPIs has been a regulatory requirement, the average number reported is eight, of which five are financial and three are non-financial.

As shown in figure 10, at least one resource area or relationship that is critical to achieving strategic objectives is identified by 81% of the companies – customers and innovation are the most common. Quantified data on those factors is less frequently reported by these companies.

Figure 10: Proportion of companies identifying drivers of strategic success

Most companies identify at least one driver of strategic success and explain how this is managed for success. Fewer provide numerical information



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Line chart base: number of companies that identified the driver

As expected, industry variations are noticeable. Physical assets, for example, are identified as critical to achieving objectives by 60% of energy, utilities and mining companies. Similarly, customers are identified as critical by 68% of financial services companies. Regionally, Japanese companies report their critical success factors most often, and US companies are least likely to identify them.

Companies in the US, Europe, Australia and Canada commonly report on executive remuneration. However, a limited link is observed between the measures reported as being used to assess executives' performance and key performance indicators identified elsewhere in the company's report – see figure 11.

Value for investment communities

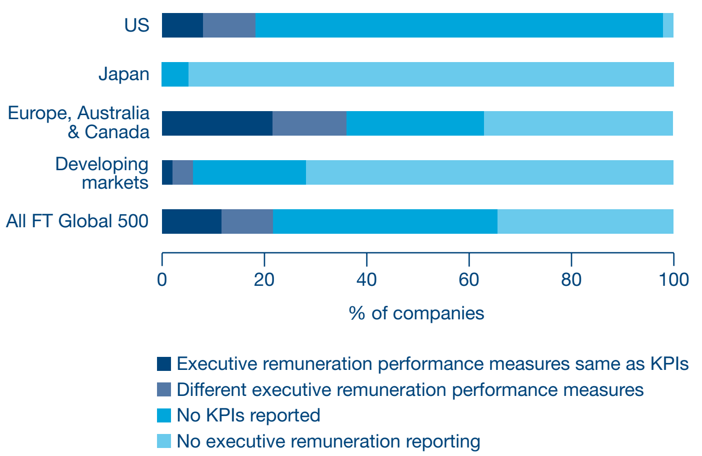
Although information about the drivers of operational performance (customers, innovation, people, etc) is valued by investors, they have little appetite for prescriptive standards in this area. Management is also quick to highlight the need for flexibility around the measures used to reflect the strategic objectives of each company.

However, there is a much stronger appetite for standardised information among investors specialising in particular industries where non-GAAP KPIs are relied on to assess performance. For example, retail investors are interested in same store sales or sales per square foot, while telecoms investors want to know about average revenue per user. Because management is the only credible source of critical industry-specific performance data, investors would like non-financial measures to be properly explained, including the bases of calculation.

Investors also want to see that the performance measures used to set executive remuneration levels are aligned to the reported strategy and KPIs of the business. This is not only seen as good governance but as a critical mechanism for enhancing shareholder engagement and for enabling a constructive dialogue between management and investors.

Figure 11: Companies' executive remuneration and KPI reporting by region

There are wide regional variations in reporting executive remuneration and in links between executive performance measures and KPIs



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Opportunities: Insights into performance

'Increase industry and investor collaboration so that industry-specific KPIs can be standardised'

Opportunities

As stakeholders come together to create an integrated information framework, the opportunity exists to satisfy investor appetite for credible, comparable, industry-specific KPIs that may well be non-GAAP measures. With the number of companies that report KPIs growing – 30% now do so – companies appear open to the opportunity too.

Successful examples of stakeholder collaboration, such as the development of proven and probable reserves measures in the natural resources industries, have resulted in companies reporting standardised KPIs that they know are of most value to stakeholders; these are calculated and reported in a consistent way within industry sectors to enhance comparability. Regulatory overlay may also play a part; using the reserves example again, some elements of these KPIs are now incorporated in GAAP in several countries.

Measures such as sales per square foot and average revenue per user are examples of standardised KPI terms. They differ from a 'standard' KPI in that there is no common agreement on what data should be included or excluded in those metrics. Mechanisms to increase multi-stakeholder collaboration so that standardised, industry-specific KPIs can be defined will be key to enhancing reporting in this area. As part of the World Intellectual Capital Institute's reporting framework development process (see page 36), multi-stakeholder working groups in Japan, the US and Europe are developing standardised KPIs for several industries, including automotive, pharmaceuticals, electronic devices, telecommunications, insurance and software.

As these collaborative processes evolve, reporting of KPIs in today's reporting model can be enhanced through clear identification of which indicators management considers key in measuring success. Explanatory information, such as the specific calculation methods adopted and the data points included or excluded from the standardised KPI, can also be helpful.

Participants in the process can also consider whether appropriate liability protection will enable companies to feel comfortable about providing forward-looking information on their KPIs. Reporting performance in the context of past expectations for success and quantifying future targets, as well as the factors that might influence their achievement, can enhance investors' understanding of the future direction of the business and the aspirations of management.

With consistent reporting of KPIs across different reporting channels, companies can reinforce how they believe success in achieving their strategic objectives should be measured by capital markets. Stakeholders can also encourage enhanced governance and alignment of management and investor interests by linking those same measures of success to executives' rewards. Clear remuneration reporting can provide evidence of such alignment rather than being primarily focused around regulatory compliance.

Impact of external trends and factors

External trends and factors have an impact on the selection of a particular strategic path and on performance against objectives, as well as future prospects. This impact is an underlying element of the integrated information framework that we outlined on page 8.

Reporting in regulatory filings

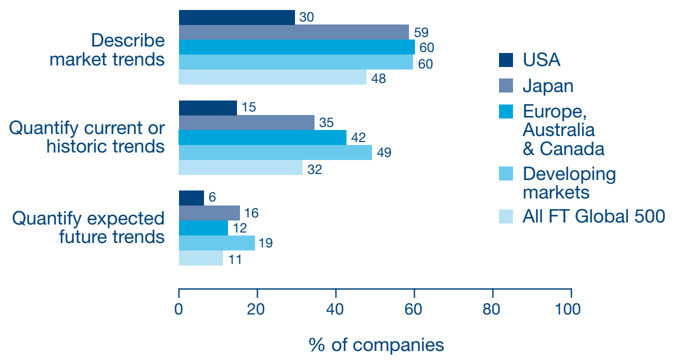
Some 60% of the FT Global 500 companies outside the US provide some information in their annual reports on trends in their marketplace. Similar information is provided in Form 10-Ks by 30% of US companies, as shown in figure 12.

Quantification of those trends from a historical perspective is given by, on average, 42% of those non-US companies (15% of US ones) and from a forward-looking perspective by 14% of them (6% of US ones).

27% of companies outside the US also use third-party information within those discussions of their market conditions, providing an alternative perspective, with 4% of US companies doing so.

Figure 12: Company reporting on market trends

Market trend data (quantitative and narrative) is more common in non-US companies



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‘Enhance visibility for all stakeholders of management’s insight into the impact of external trends and factors’

Value for investment communities

Investors value insight into management’s view of the external trends and factors likely to influence a company’s future performance. It helps them to understand why management has chosen a particular strategic path – putting those strategic decisions in context – but this insight is often provided outside the regulatory reporting model, in face-to-face briefings from management, for example. Investors also value being able to compare management’s view of the market with that of other sources, including competitors.

Many argue that management’s ability to make this information available to the market should reduce the risk to subsequent claims when things go wrong, provided management has approached the disclosures with due care and attention.

Opportunities

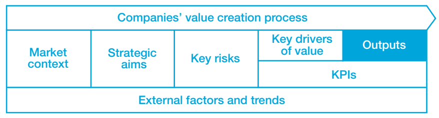
Within industry sectors, similar external trends and factors will be relevant to most companies. Already, information on these is often referred to by investors – for example, regulatory bodies in industries such as aviation provide consolidated data on key industry trends.

Stakeholders have the opportunity to evolve regulatory reporting as they develop an integrated information framework to ensure management’s own insight into, and quantification of, those trends and factors is visible to all stakeholders. Enhancing the credibility of that insight can be achieved through providing third-party data, for example from industry bodies, with external assurance of the information where this adds value.

Our research shows that investors also value management’s outlook for the future but that management can feel exposed to litigation in providing this. As stakeholders come together to create an information framework, the opportunity exists to address this exposure.

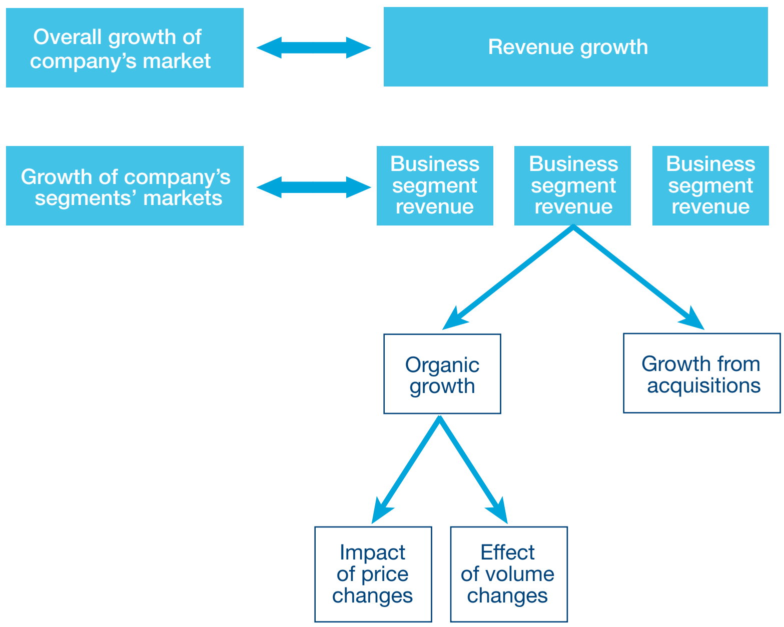
Opportunities to address reporting issues
Reporting different levels of information

A hierarchy of information, from ‘at a glance’ through to granular detail, provides a sound foundation for reporting



We use the term ‘information hierarchy’ to describe the different levels or degrees of detail in which data is reported to investors. Overall turnover and profitability is important, but gaining a real understanding of performance requires the provision of other elements of information as the example below highlights. Understanding this hierarchy is essential to facilitate the effective flow of information between companies and investors.

Figure 13: Information hierarchy example



As this diagram highlights, information on growth in turnover is valuable when broken down into organic growth and growth resulting from acquisitions. It is important to structure thinking on the basis of an ‘information hierarchy’ across the whole reporting framework. This will be critical to the development of a more efficient reporting model, which in turn can provide a sound basis for developing a reporting taxonomy that harnesses the enormous potential of web technology.

For the purpose of this paper we have applied this thinking to three areas of the reporting model:

- Segment information
- Underlying operating performance
- Debt disclosures

Segment information

A good understanding of performance by segment is fundamental for both management and investors to assess which areas of a business are most productive and where value is – or isn't – being added.

Reporting in regulatory filings

Segment reporting currently represents, on average, 17 pages or 15% of the narrative section and four pages or 6% of the financial statements, but this picture hides considerable variation. For example, a quarter of companies in the rapidly developing capital markets provide no segment information at all.

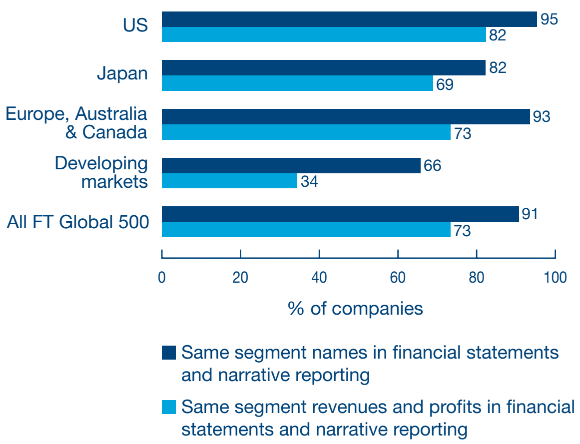
83% of the FT Global 500 companies use business units as their primary basis for segment reporting in financial statements. The average number of business segments reported is between four and five. 73% of companies have five segments or less and a further 24% have between six and nine. Some 4% of companies report using a single business segment.

The vast majority (91%) of companies are consistent in using the same descriptor or names for each segment both in the notes to the accounts and in the management commentary. The actual numbers used for revenue and operating profit differ between the notes and the commentary in 27% of companies – see figure 14.

Reporting levels of individual line items by segment varies widely, and is highly dependent on the regulatory model being followed. For example, segment assets are commonly required and reported (by 80% of companies), with cash flow by segment reported by just 1%.

Figure 14: Segment reporting consistency by region

Companies in developing markets have the least consistency between narrative and financial statements segmental reporting



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Value for investment communities

Segment reporting is classed as highly important by the vast majority of investors (nearly 80%). This reflects the fact that different business segments have different business models and different risk/return characteristics. To mix apples with pears can have serious implications for how investors value the business. With most valuation models built from the segment level up, the importance of this information is not surprising. However, this remains an area of reporting where investors are dissatisfied with the information they receive – just 10% see segment reporting in the regulatory model as adequate. Reasons given for this perception include lack of comparability because of frequent segment changes, too few segments identified, and insufficient granularity per segment. Inconsistencies between segment information in different communications can also hinder clarity.

Over 80% of investment professionals surveyed for our research would like management to identify segments primarily by business unit. Just over one third support determining what those business units should be on the basis of 'through management's eyes', with less support for this approach in the US than in the rest of the world.

Investment professionals would like to see additional line items reported by segment – many of them suggest that these include operating cash flow, capital employed and working capital.

'Providing an effective bridge between management reporting on segments and investor analysis is a key opportunity'

Opportunities

Providing an effective bridge between management reporting on segments and investor analysis is a key opportunity as stakeholders build up the integrated information framework.

There is an opportunity to bring a segment perspective to reporting of all aspects of the integrated information framework, whether that is to describe the strategies of a business segment, to outline risks, or to provide operating and financial performance data, such as capital employed, working capital and operating cash flow.

Underlying operating performance

A high level of aggregation is necessary to present the summary information – such as total revenues – required in financial statements. However, sufficient disaggregation is also critical to be able to fully understand the components of underlying operating performance and changes in these summary numbers from one period to the next.

Reporting in regulatory filings

Our first survey of the world's largest companies, published in April 2007, indicated that reporting an analysis of the components of revenue growth – such as price, volume, currency, acquisitions and disposals – was not common. Of these elements, the impact of volume changes was the one most likely to be explained (30% of companies), with disposals (perhaps a less common event) being the least likely (10%).

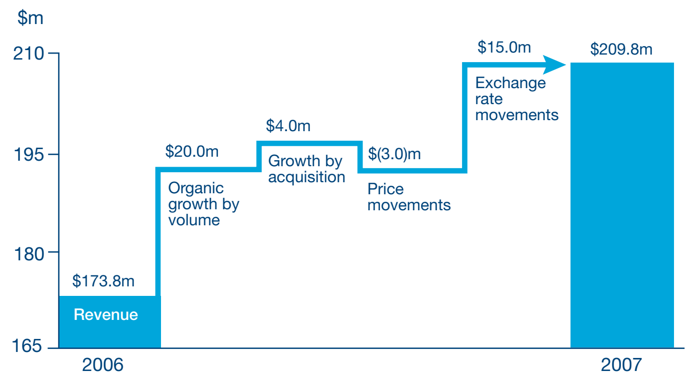
An accessible way to present such information clearly is through graphics that illustrate the transition of revenue from one year to the next (such as a 'revenue bridge', see figure 15). This can be supplemented by more detailed explanations of revenue movements. In our latest survey we found that just 6% of companies used a graphic in this way. Those companies that do so are more likely to come from Europe, Australia and Canada.

Value for investment communities

Our research has found that investors stress the importance of being able to distinguish underlying operating performance from both one-off events (such as a gain from the sale of a business) and the effect of the re-measurement of assets or liabilities required by accounting standards.

The majority of investors surveyed believe an analysis of revenue and earnings by 'organic vs acquired' is important as it offers them a greater understanding of the components underpinning growth and an insight into the sustainability of performance.

Figure 15: Illustrative presentation of a revenue bridge



Opportunities

There are opportunities to create an integrated information framework that both enhances reporting about underlying operating performance and simplifies it.

Enhancement can come from considering the depth and breadth of information that should be included in the framework – what information should be reported on the specific factors driving performance? Will this allow underlying operating performance to be distinguished from the impacts of acquisitions and disposals or the effects of currency movements?

Stakeholders might also want to ensure that mechanisms for liability protection are built into the reporting model as these can help management provide a forward-looking view of the sustainability of operating performance.

'Consider what information is needed in the framework to allow the underlying operating performance of companies to be understood'

Debt disclosures

A clear picture of a company's debt position and the risks associated with a company's funding profile is a critical component of investors' valuation models. Debt disclosures can also provide an understanding of management's plans for servicing that debt.

Reporting in regulatory filings

Debt reporting varies in terms of its depth and quality and is typically fragmented through a series of separate disclosures within the regulatory filings. An analysis of net debt – grouping debt information into one place – is rarely provided by companies (6%), regardless of region or industry.

Furthermore, the nature of information reported in regulatory reports rarely provides the breadth and granularity of disclosures needed to understand a company's funding structure and exposure to changes in market volatility and liquidity.

‘Simplification of how debt information is presented can also be considered by stakeholders as they determine what information to include in the framework’

Value for investment communities

Our research highlights that fixed-income investors, in particular, want to gain a comprehensive picture of indebtedness, including the company’s overall debt position and debt repayment schedule. They want to understand the underlying operational cash flow and the financial and operational risks associated with it.

Investors rarely find all the debt information they need in corporate filings. Consequently, they supplement the company information on debt with other sources, such as the funding information provided by Bloomberg or the credit rating agencies.

From the corporate perspective, management provides the debt information demanded by regulation. The fact that more granular information is available through other sources has become an accepted part of the overall model (particularly as it is linked to credit rating), yet some aspects of debt information cannot be obtained through these channels – for example, details of bank loan structures or unquoted bonds. This kind of complexity or ‘workaround’ introduces the potential for inefficiencies into the reporting process.

Opportunities

Debt investors have an important contribution to make in the development of an integrated information framework to enhance and simplify reporting. As the framework evolves, information relevant to a full understanding of a company’s debt position and management’s funding strategies can be factored in. But this need not focus exclusively on measurement of debt. Disclosure can be equally valuable, for example by enabling people to drill down into more detailed data about individual debts, maturity profiles and debt covenants. Again, technologies such as XBRL will have a role in improving access to broader and more in-depth debt information.

Simplification of how debt information is presented can also be considered by stakeholders as they determine what information to include in the framework. Bringing all information on debt together in the financial statement notes, for example, could alleviate the difficulty some investors have identified in accessing the information they need. Taking this a step further, a ‘statement of debt’ could be considered within the information framework, perhaps even within the current regulatory model, where permitted.

Conclusion

The specific opportunities identified in this paper are just a few of those available to capital markets participants to move forward with the process of creating an integrated information framework and recasting the reporting model.

We hope these initial thoughts can act as a catalyst for new thinking, new ideas and a fresh approach from all stakeholders in the reporting process. The opportunities presented have a user-centric focus and are principles-based. We have also tried to focus on those that ease preparation, understanding and access of reporting for both companies and investors. Our suggestions also support integration of financial, contextual and non-financial information.

When a new, market-driven blueprint for corporate reporting is developed as a result of these debates and discussions, the prize will be enhanced, yet simplified, reporting, more effective and efficient capital markets and a major contribution to creating a more sustainable world.

Appendix 1
Research methodology

Many of the references in this discussion paper to the way that companies currently report and the value of information to investment communities are based on the findings of PricewaterhouseCoopers' research

FT Global 500 research methodology

References in this discussion paper to the way that companies currently report are based on the previously unpublished results of a desk-top research project undertaken by PricewaterhouseCoopers during 2007. This involved a detailed review of the primary regulatory filings, relating to year ends between 1/1/2006 and 31/12/2006, of the members of the FT Global 500 as at June 2006.

This study follows on from our earlier survey *Corporate reporting – a time for reflection*, which analysed the narrative reporting of the Fortune Global 500. It is of note that the FT Global 500 classification is based on the market capitalisation value of the companies whereas the Fortune Global 500 is based on their revenue. Accordingly, the companies surveyed in these two years are not exactly the same ones. However, around 280 companies are found in both groups, providing a degree of comparability.

Documents assessed

Reflecting the regulatory regimes in which the FT Global 500 operate, the majority of the filings analysed in this survey take the form of annual reports (55%), with another 191 filings (38%) being Form 10-Ks – see figure 16. A further 4% comprised other documents such as Form 20-Fs or territory-specific filings. 17 companies could not be assessed, either because the information was not available or due to mergers/acquisitions during the period being considered.

To ensure that we were comparing like with like, where a Form 10-K specified that it had "incorporated by reference" any elements of a proxy statement (covering disclosures of, for example, executive remuneration or corporate governance issues), these specific pages were included in our review. Similarly, where a Form 10-K specifically incorporated pages from an annual report, these were also analysed.

Assessment criteria

The review was conducted in the light of best practice guidance currently in issue, such as the European Union Modernisation Directive legislation and additional supporting material provided by regulatory bodies. It also draws on previous research conducted by PricewaterhouseCoopers, particularly where this has highlighted the views of management and investors around the information that is needed to understand performance and value a company.

Research sample

Companies making up the FT Global 500 come from a range of geographies and industries – see figure 17. By geography, 39% are from the US, 37% from Europe, Australia and Canada, 12% from Japan and 12% from rapidly developing capital markets. By sector, financial services account for the largest number of FT Global 500 companies (28%), and energy, utilities and mining (EUM) the smallest (16%).

Figure 16: Documents assessed

Financial years ending in:				
	2006		2005	
	FT Global 500		Fortune Global 500	
Form 10-K	191	38.2%	157	31.4%
Annual report	273	54.6%	286	57.2%
Other	19	3.8%	36	7.2%
Not scoreable	17	3.4%	21	4.2%
Total	**500**	**100%**	**500**	**100%**

Figure 17: Number of companies assessed by industry and region

Industry group	Current year / Prior year	US	Japan	Europe, Australia and Canada	Rapidly developing capital markets	Total
		Region				
Automotive and industrial products	Current year	31	20	28	6	85
	Prior year	33	36	49	5	123
Energy, utilities and mining	Current year	23	4	38	14	79
	Prior year	16	10	29	17	72
Consumer, retail, pharmaceutical and healthcare	Current year	51	12	30	4	97
	Prior year	59	7	33	2	101
Financial services	Current year	42	34	60	16	134
	Prior year	34	11	58	6	109
Technology, infocomms, entertainment and media	Current year	43	8	22	15	88
	Prior year	30	16	23	5	74
Total current year FT Global 500		190	58	178	57	483
Total prior year Fortune Global 500		172	80	192	35	479

Other reference sources

This discussion paper also draws on previously published PricewaterhouseCoopers' research reports, including the following:

Measuring assets and liabilities: Investment professionals' views
February 2007

Corporate reporting – a time for reflection: A survey of the Fortune Global 500 companies' narrative reporting
April 2007

Corporate reporting: Is it what investment professionals expect?
November 2007

Performance statement: Coming together to shape the future
December 2007

See pages 37

Appendix 2
Summary proposals from SEC's Advisory Committee on Improvements to Financial Reporting

The SEC committee's draft decision memorandum sets out strategically important proposals for improving US financial reporting

In July 2007 the SEC set up a committee, chaired by Robert Pozen (chairman of MFS Investment Management in Boston and former vice chairman of Fidelity Investments), to consider improvements to US financial reporting. In January this year the committee published a draft decision memorandum setting out its initial development proposals.

The proposals are focused on the US reporting model, and the role of the SEC and the FASB, but we believe they are strategically important and provide an understanding of the direction of US thinking.

Key points:

- Regulators should enhance their materiality framework to enable greater use of qualitative factors and professional judgements.
- Regulators need to accept reasonable professional judgements made by preparers and auditors.
- US GAAP should move towards more 'principles-based standards'.
- Standard-setters should proceed with caution in expanding the use of fair value measurements beyond financial assets and liabilities.
- XBRL technology has compelling merits and on 30 May the SEC released a Proposed Rule that would mandate XBRL as a filing format for company submissions to be implemented starting with the Fortune 500 for periods ending after 15 December 2008. Other equity regulators in China, Japan, Korea, Singapore, Spain and elsewhere have already mandated XBRL for company reports.

Key areas:

The report is structured into four key areas. The main elements of each section are as follows:

Substantive complexity

Here the main recommendation is that GAAP should be based on activities rather than industries, recognising that for some industries, where the economics are legitimately different, an industry focus is acceptable. Importantly, the committee's work is not complete and it indicated that it would be focusing on the need for better education around the importance of understanding the economic substance of transactions in contrast to mechanical compliance with rules. Furthermore, it indicated that the committee may look into whether the FASB should consider the development of a measurement framework to help determine the most appropriate measurement basis in a given situation, and to refrain from issuing new standards and interpretations that require the expanded use of fair value until such a framework is complete.

Standard-setting process

The report comments that while the US system has been "quite effective", it has evolved over many years with some of the basic principles becoming obscured by detailed rules, bright lines, exceptions and regulations, which reduce the transparency and usefulness of the resulting financial reporting. The main recommendations here are:

- Additional user/investor involvement in the standard-setting process is central to improving financial reporting.
- The creation of a formal Agenda Advisory Group, improving the prioritisation of work, procedures for field testing, field visits and cost benefit analysis.
- SEC to encourage an objective-based approach to the way standards are designed and implemented.

The committee is also considering proposing that the SEC formally encourages improvement in the way standards are written – using an agreed-upon framework which promotes trust and confidence in efficient markets by encouraging the use of professional judgements made in good-faith.

Audit process and compliance

This section of the report principally considers two issues: financial restatements and the use of professional judgement. Here the committee recommends that the commission or its staff issue guidance reinforcing the following concepts:

- Evaluation of materiality should be based on the perception of a reasonable investor.
- This should reflect how an error impacts the total mix of information available to a reasonable investor.
- The evaluation of errors should be on a sliding scale where qualitative factors influence the decision.

Professional judgement gets a major airing and the committee recognises that "many regulators appear to encourage a system in which professionals can use their judgement in determining the most appropriate accounting and disclosure for a particular transaction". In this context the committee recommends that the SEC should issue a policy statement or adopt a safe harbour on a professional judgement framework consistent with the concepts, where the proposed framework would be applicable to accounting-related judgements.

Delivering financial information

The committee agreed that information delivery must be provided in a manner that will make it efficient, reliable and cost effective for each relevant investor group and will not significantly increase burdens on the reporting companies. It principally focused on tagging of financial information (XBRL) and improved corporate website use. It specifically recommended that the SEC should mandate the filing of XBRL-tagged financial statements within a defined timeframe after certain preconditions are met, which relate to the successful taxonomy testing and capacity of reporting companies to file using XBRL. Assurance was not initially recommended but the committee proposes initiating a voluntary pilot programme to evaluate the potential costs and benefits associated with it. Furthermore, it was recommended that the SEC should issue a new comprehensive interpretive release regarding the use of corporate websites for disclosures of corporate information.

Finally, the committee also highlighted its intention to look at the following issues in the future: use of executive summaries as an integral part of periodic reports, disclosure of KPIs and other metrics to enhance business reporting, improved quarterly press release disclosure and timing and finally, the continued need for improvements in the management discussion and analysis (MD&A).

> We believe the draft memorandum has real substance and should be seen very positively by those outside the US. Clearly, it is only the beginning of a process of change, but it is an encouraging one. This is not only because of the issues being identified and addressed, but also because without this contribution the process of convergence to a higher quality reporting model would be even harder to envisage.

Appendix 3
Regulatory frameworks

To understand the current shape of reporting and how it varies around the globe, it is important to recognise the impact that the local regulatory environment has had

Clearly, the widespread adoption of International Financial Reporting Standards (IFRS) around the world is encouraging greater comparability of financial performance, regardless of the jurisdiction in which a particular entity is regulated. Similarly, the on-going development and adoption of International Standards on Auditing is bringing assurance processes around the world into closer alignment.

Nevertheless, considerable variations persist in terms of the reporting requirements placed on companies by local regulators. In the US, for example, the regulations around the Form 10-K – the primary regulatory filing – have the dominant impact on content. Furthermore, the legislative structure of US society and its business environment has, over time, resulted in a reporting model that tends to be rules-based and where, for understandable reasons, an environment of legal compliance rather than judgement has emerged. In other parts of the world, the regulatory regime is often more principles-based and provides greater scope for professional judgement about the form and content of annual reports.

For the areas of reporting covered in this discussion paper, the regulatory framework against which companies around the globe operate is very variable. This may provide some explanation for the variability in reporting, despite many companies and investors recognising the importance of this information.

Contextual information

There is an increased focus around the world, both in company law and by standard setters, on the need for standards or guidance on narrative reporting. In the US this area is addressed by the SEC's Management's Discussion and Analysis guidance. In the European Union parameters are set by the Modernisation Directive. Although current disclosure requirements tend to be driven by securities regulators, who prescribe contextual information headings and content, greater convergence around the world is being seen as attractive. The International Accounting Standards Board is refocusing on its Management Commentary project, which will have an important part to play in developing this area. Currently, the IASB is working to develop best practice guidance.

Insights into performance and prospects

Again there are variations in corporate reporting of past and future performance indicators, reflecting local regulatory requirements. In Europe, for example, the EU Modernisation Directive includes a requirement for the reporting of KPIs. In the US the SEC has set conditions for the use of non-GAAP financial measures.

There is a growing perception that more standardised industry-specific measures would be helpful to investors and enhance comparability of corporate performance. For example, the insurance industry has taken up the challenge of agreeing a definition of embedded value and other specialist terms. Risk reporting is highly variable. Some models are legalistic and prescriptive, leading to boilerplate disclosures that may mask what is really important. However, some risk disclosures are covered in financial reporting, as in connection with financial instruments. Greater adoption of IFRS could encourage improved consistency around the world.

Information hierarchy: segments, operating performance and debt

Standards have been developed for segment reporting, but inconsistencies remain around the world. Encouragingly, the alignment of the standards for segment reporting between the US and the IASB, which requires companies to adopt a 'through the eyes of management' basis, should lead to greater consistency of reporting, providing the spirit of the standard is not abused. Huge flexibility exists in the way that companies report on their growth. However, many companies don't make the most of the opportunities open to them. For example, there is typically nothing in the various regulatory models to prevent the use of tables, charts, graphics and other techniques to improve the presentation of information.

Regulatory models appear to have relatively little relevance to investors in terms of disclosures around funding and debt information. Investors appear to rely more heavily on alternative sources of information, using independent third parties such as credit rating agencies to obtain the granularity and breadth of data they need.

Exhibit 1: Examples of guidance and legislation on narrative reporting

Guidance	
IASB	Discussion paper on Management Commentary (published October 2005)
IOSCO	International Organisation of Securities Commissions General Principles Regarding Disclosure of Management's Discussion and Analysis of Financial Condition and Results of Operations (published February 2003)
Australia	Group of 100's Guide to review of operations and financial condition (published 1998, updated 2003)
Canada	CICA guidance on MD&A disclosure (published November 2002, updated May 2004)
UK	Accounting Standards Board Reporting Statement: Operating and Financial Review (published January 2006)
US	SEC Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations (published December 2003)
Legislation	
European Union	Article 46 of EU 4th Directive and Article 36 of 7th Directive (published May 2004)

Appendix 4
Summary of Big Six firms' discussion paper: 'Principles-based accounting standards'

On 15 January 2008 the fourth Global Public Policy Symposium was hosted in New York by the chief executive officers of the six largest network accounting firms

More than 250 senior officials and executives from financial communities around the world came together at the 2008 Global Public Policy Symposium to exchange views on how collaboration will help maintain healthy global capital markets and contribute to improvements in the quality, reliability and accessibility of financial and other information.

A discussion paper on principles-based accounting standards was released jointly by the six accounting firms at the symposium. The paper proposes a framework for discussion that emphasises accounting standards which align with economic reality, are responsive to the need for transparency and recognise the necessity of using appropriate professional judgement.

The following is a summary of some of the key messages in the white paper.

Accounting standards are too complex

Today's financial statements are so complex that even the largest companies struggle to get them right and make them meaningful, and sophisticated investors struggle to fully understand them. Although business transactions are complex, accounting rules often introduce unnecessary additional complexity. Many have recognised this problem and are looking at ways to reduce unnecessary accounting complexity. Principles-based standards will help in that effort.

Accounting should reflect economic reality

A goal of principles-based accounting standards is to encourage preparers, auditors and standard-setters to achieve financial reports that more closely reflect economic reality. Some argue that reflecting economic reality will cause more income statement volatility. The fact is that economic volatility is a market reality. Rather than using detailed rules to obscure this volatility, investors and all stakeholders will ultimately be better served by having access to clearer information about volatility that actually exists. If investors come to accept volatility as being natural, it could create a shift in mind-set that de-emphasises short-term earning measures and puts greater emphasis on the underlying fundamentals that drive the value of businesses.

Transparency in financial reporting

Financial reports prepared using principles-based standards require transparent disclosure to ensure investors understand and have confidence in management's judgements. Financial statements must be prepared with the end user – the investor – in mind. Information relevant to end users includes: disclosures about the underlying cash flows of transactions and how the financial information can be used as a predictive tool (eg, enable users to predict future cash flows); information on the fair values of assets and liabilities and changes therein; and clear communications about fundamental judgements made by preparers to allow investors to compare companies.

Embrace and accept professional judgement

Preparers and auditors of financial statements must put more emphasis on the exercise of professional judgement to faithfully report the economic consequences of transactions. Investors are best served when financial reports are clear and easy to use and understand. In order to deliver on that goal, preparers and auditors must be allowed to exercise professional judgement. They must feel confident that fundamentally sound and well-documented judgements will not be subject to unwarranted second-guessing. Regulators, standard-setters, auditors and users should understand that allowing the exercise of reasonable judgement will result in some diversity in reporting. Such diversity should be acceptable as it is a natural consequence of principles-based standards that better reflect economic reality and provide investors with better information upon which to make investment decisions.

The way to move forward

This discussion paper is designed by the large firms to act as a means to engage various stakeholders in discussion and to build consensus on the approach to use going forward. All interested parties are encouraged to embrace the changes needed to lead the financial markets to more principles-based standards. Market participants are also encouraged to challenge standard setters, such as the FASB and the IASB, through the public comment process, to develop and adopt standards that more fully reflect a principles-based approach. Lastly, it is clear that the behaviour of regulators, preparers, auditors and other market constituents will need to change to achieve principles-based standards.

Appendix 5
World Intellectual Capital Initiative

In December 2007, the World Intellectual Capital Initiative (WICI) was formed to promote better corporate reporting

Founding members of WICI include the following organisations:

- Enhanced Business Reporting Consortium (EBRC)[1] – of which PricewaterhouseCoopers is a founding member
- European Federation of Financial Analysts Societies
- Ministry of Economy, Trade and Industry (Japan) (METI)
- Organisation for Economic Cooperation and Development (OECD)
- Society for Knowledge Economics (Australia)
- University of Ferrara (Italy)
- Waseda University (Japan)

Members of the WICI network have agreed to collaborate to promote enhanced corporate reporting, both in terms of content and format. To this end, members are using a Wikipedia-style collaborative Internet platform to participate in developing and implementing a global business reporting framework, key performance indicators and related XBRL taxonomies. This inclusive market-centric process allows for initial framework drafts to be shared among members. Subsequent iterations of these drafts are driven by the collaborative commenting capability of the platform. Similar processes have been employed in developing GAAP XBRL taxonomies in several territories.

1 The Enhanced Business Reporting Consortium (EBRC) was founded by the American Institute of Certified Public Accountants (AICPA), Grant Thornton LLP, Microsoft Corporation, and PricewaterhouseCoopers in 2005 upon the recommendation of the AICPA Special Committee on Enhanced Business Reporting. The EBRC is an independent, market-driven, non-profit collaboration focused on improving the quality, integrity and transparency of information used for decision-making in a cost-effective, time-efficient manner.

Further information
Insights into corporate reporting

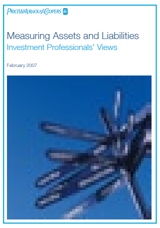
For good practice examples of corporate reporting and copies of our research and publications on key corporate reporting issues, please email info@corporatereporting.com or visit www.corporatereporting.com

Corporate reporting – a time for reflection

During 2006, PricewaterhouseCoopers surveyed the narrative reporting practices of the world's largest companies, the Fortune Global 500. Its objective was to provide answers to questions such as: What do the narrative discussions actually communicate? Are companies meeting the information needs of investors, their priority audience for these strategic communications?

Corporate reporting: Is it what investment professionals expect?

What is the investment community's view of the current corporate reporting framework? What do they see as its strengths and weaknesses? Based on interviews with over 250 analysts and investors around the world, this report provides unique insights into the corporate reporting agenda.



Measuring assets and liabilities: Investment professionals' views

How do investment professionals use the balance sheet? How do they want assets and liabilities to be measured? This publication offers thoughts from participants in the major global capital markets.

Report Leadership

Report Leadership, a multi-stakeholder group, focused on the annual report to develop simple, practical ways to improve narrative and financial reporting to the capital markets. Reflecting input from a range of investors, the publication outlines some far-reaching, yet practical, ideas for improving the content of annual reports and other communications. These ideas have been received very positively, not least by the UK Hundred Group of Finance Directors. The contributors to this initiative are the Chartered Institute of Management Accounts (CIMA), PricewaterhouseCoopers, Radley Yeldar and Tomkins plc.

Performance statement: Coming together to shape the future

Communicating financial performance has been a core ambition of reporting standards since their inception. In this survey of both investment professionals and corporate management, we compare and contrast their perceptions of the information needed to achieve that long-held ambition and offer insights into where the gaps in current reporting practice lie.

World Watch: Governance and corporate reporting magazine

This global magazine provides insights into governance, financial reporting, broader reporting and assurance issues. It includes news and opinion articles to help inform executive and non-executive directors, regulators, standard setters, academics and investors. The magazine is published twice a year and circulated in 94 countries. To subscribe, email sarah.grey@uk.pwc.uk.

www.corporatereporting.com

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