The future of corporate reporting: towards a common vision

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Foreword

By Michael Andrew, Chairman, KPMG International

The downturn that has affected nearly every part of the global economy has called into question some basic tenets of our economic system. We are still learning the lessons from a financial crisis that has shaken capitalism to its core, as we collectively strengthen our model for the future.

Good corporate reporting has an important role to play in helping to restore the trust that has been lost. Companies need to communicate more clearly, openly and effectively with investors and other stakeholders about how they plan to grow in a sustainable way. For their part, stakeholders are demanding greater transparency around strategy, business models and risks, and the commercial prospects of the enterprises and institutions with which they engage.

The adoption of International Financial Reporting Standards in more than a hundred countries has brought increased comparability of financial information for the global capital markets. However, more generally there are valid concerns about increased complexity and disclosure overload in current financial reporting. Moreover, financial statements are only one element of the corporate reporting chain. Investors obtain key information from many other sources, including directors' reports, earnings releases and analysts' presentations.

Notwithstanding the importance of high-quality corporate reporting to the efficient operation of capital markets, the debate about change so far has been about making marginal – normally incremental – changes, rather than a more fundamental consideration of the adequacy of corporate reporting in meeting 21st century needs.

One exception to this is integrated reporting, as currently being developed by the International Integrated Reporting Council. This represents a significant evolution of current corporate reporting and provides a longer-term vision for the future which is gaining momentum. But the debate is still young and it remains to be seen whether integrated reporting represents the best solution. This depends on the answers to some quite fundamental questions. For example:

- Does it remain appropriate that the fiduciary duty of directors is primarily focused on shareholders?
- What change in the corporate reporting model do investors want to see?
- How will an evolving model affect the responsibilities of boards and audit committees. For example, do they have a responsibility to ensure that the directors’ report is fair and balanced?
- As the focus shifts to other forms of reporting, with more emphasis on forward-looking information and story-telling, will there be a need for more, or other, forms of assurance beyond the financial statement audit? For example, does there need to be assurance of key performance indicators, both financial and non-financial, that are the real drivers behind value creation?
- And what is the role of technology in making big data more accessible for stakeholders involved in corporate reporting?

This report offers a range of views from opinion leaders in their respective fields with regard to these themes, and their preferred direction for corporate reporting. We at KPMG sought to collect these opinions because we believe it is time to debate these issues, to start developing a common view on the direction for corporate reporting over the next five to ten years.

If there is one point of consensus among the interviews that follow, it is that corporate reporting definitely needs to move on. It has to evolve if it is to be fit for purpose in a rapidly changing world.

The key question is: how?

I hope you will find our interviewees’ perspectives on this question interesting and stimulating.
Introduction

By Mark Vaessen, Partner, KPMG in the UK and Global IFRS Leader

The future of corporate reporting: towards a common vision

The interviewees comprise:

- **two standard-setters**
  - Hans Hoogervorst of the IASB
  - Mervyn King of the IIRC

- **three users**
  - Julie Hudson of UBS
  - Neri Bukspan of Standard & Poor’s
  - Sandra Peters of the CFA Institute

- **three preparers**
  - Christoph Hütten and Mark Deinert of SAP
  - Russell Picot of HSBC

- **two regulators**
  - Stephen Haddrill of the FRC
  - Brian Hunt of the CPAB

- **one auditor**
  - Joachim Schindler of KPMG International

As the world slowly recovers from the ‘Great Recession’, it is time to consider where corporate reporting goes next. One of the lessons from the crisis is that we lacked insight into the risks that were building up, both in the system and among companies. How can we delve deeply into the health of the private sector if our corporate reporting standards and practices are not up to the job?

Admittedly, there were already warning signs to be found in corporate financial statements prior to 2008, if people had looked hard enough. And as we peer into the future, we must not think that corporate reporting is a magic elixir; companies and their executives need to be held accountable for taking excessive risks. But the fact is that even if there had not been a financial crisis, we would need to consider changing the current reporting model.

This report begins with the premise that the current reporting model needs to be improved. But it is a matter of debate as to how – and how far – it should change. Our objective in presenting this report is to encourage a debate. It is based on interviews with 10 leaders in the field of corporate reporting, and represents a cross-section of opinion. All of them believe that changes to the reporting model are needed, but they hold widely differing views on exactly what needs to be altered and how.
The need to raise the bar

So what is the debate about? Our interviews show that it is increasingly difficult for the corporate reporting model to meet the needs of users, preparers, auditors and regulators. Investors want forward-looking information about strategy, business models and the ability of the company to create sustainable long-term value. Preparers need to connect the dots better in their public communications so that the balance of risk and opportunity is clearer. Regulators are demanding much more information from companies and more accountability from boards and managers.

Standard-setters are equally dissatisfied. They believe that the bar needs to be raised for corporate reports. “The financial crisis was very much caused by faulty economic standards, faulty prudential standards or the abuse of standards and the gaming of capital requirements,” says Hans Hoogervorst, the chairman of the International Accounting Standards Board, the independent standard-setting body of the IFRS Foundation. “Clearly the market economy can only function well if it has a very solid set of standards and rules, and financial reporting is a very important part of that.”

All the interviewees agreed that corporate reports provide a good assessment of the financial condition of a company at a specific point in time. “In most cases, ticking the compliance box is something that financial reports do extremely well, but they are not conveying information in a clear and concise way; this view of financial reporting is held by institutional investors as well as among individual investors,” says Russell Picot, Group Chief Accounting Officer at HSBC.

Several of the interviewees said that the reports are backward-looking, that they’re too complicated and that the main points in reports are poorly connected to each other. One interviewee who holds this view is Mervyn King, chairman of the International Integrated Reporting Council (IIRC), which is developing a new reporting framework that integrates strategy, governance, performance and long-term prospects. He says the average user finds corporate reports “incomprehensible.” The current reporting model is like “looking in the rearview mirror,” when in fact “the road ahead is very turbulent and there are huge impacts on the company, both societal and environmental.”

This makes it difficult for investors to assess the risks and the future direction of the company, both in the short- and long-term. Like many of those interviewed for this report, Picot is critical of the quality of the risk analysis that companies publish. “It’s weak right now: you get a long description and a lot of numbers, but I think there are not many good examples of disclosures showing how a company has responded to changing risks and its use of relevant metrics,” he says. This is especially important for financial institutions. “We need to create a forum where banks can talk to investors, find out what they are worried about and respond rapidly to provide them with information,” he says.

Many interviewees said there was too much information in the corporate report. But not all accept the idea that corporate reports are weighed down with too much detail. One who doesn’t is Sandra Peters of the CFA Institute, who has been monitoring the views of the institute’s members. They are telling her that “it is not necessarily the volume of information, but the lack of a comprehensive story, which is where improvements in financial reporting are needed. Investors tell us there is a lack of ‘connecting the dots’ or pulling things together to communicate a cohesive story about a company’s results,” she says. Neri Bukspan, Executive Managing Director and Chief Quality Officer of Standard & Poor’s Ratings Services, concurs and also makes a plea for ‘plain English.’ He adds: “We need to improve the information about what management thinks of the business in the context of its key performance indicators.”

Improved technology is going to help cut through the clutter. In particular, new software programs will enable preparers, auditors and users to handle ‘big data,’ the seemingly overwhelming flood of information that pours in and out of companies every day. “This will enable management and investors to understand why things are the way they are. Before, the focus of corporate reporting was on the ‘what,’ says Christoph Hütten, Senior Vice President and Chief Accounting Officer at SAP. Extensible Business Reporting Language (XBRL) will also help to link data points. It is true that technology is a necessary condition for enhanced transparency. But it is not sufficient by itself. There is no substitute for human judgment, in particular in deciding how to cater better to the needs of investors.”
What investors want

Just as beauty is in the eye of the beholder, investors inevitably call the shots with regard to the importance of various communications from the company. And it is clear that they use the different forms of statement by companies in evolving ways. The financial statement (see box), summarizing and detailing the financial performance and balance sheet of the company, is a historical record that is treated as a work of reference. As investors (and executives) have focused more and more intensely on the short term, attention has shifted to the quarterly reports, but even these are losing their influence as a market-moving indicator, says Hütten. “To catch the news, investors tend to rely on the quarterly press release and SAP’s conference call with financial analysts the same day of the release. And they use the quarterly report as an encyclopedic source for the details,” he says.

As the focus shifts from financial statements to other types of corporate communication, such as analysts’ briefings, should the latter be subject to some kind of assurance? “The main point is that any assurance needs to have a value to whomever it is provided. If this assurance provides insight and comfort to the audit committees, I am sure they will want auditors to look at it,” says Joachim Schindler, Global Head of Audit for KPMG International.

One question is how to craft a corporate report that looks forward in a way that is useful for readers. The directors’ report is crucial in this regard, because it provides a platform for the executives to explain the business model and the company’s strategy for pursuing its business objectives. The directors’ report should analyze as clearly as possible the risks the company may face in aiming to reach those objectives and how it plans to prepare for these possible eventualities.

Until now, however, most corporate reports are somewhat disjointed and there are often no clear links between the directors’ report and the financial statements. This is one weakness that integrated reporting focuses on, by telling the company’s story comprehensively and more effectively connecting all the information that is important for understanding the long-term health of the company. Many of those extolling the need for integrated reporting want to see a greater emphasis on environmental, social and governance (ESG) issues. Right now, many companies provide a sustainability report that discusses ESG matters, but this is usually separate from the main corporate report.

Mervyn King is one advocate of integrating sustainability reporting into the corporate report. Julie Hudson, a managing director at UBS, is another. In her view, there is no reason why ESG issues cannot be integrated into the corporate report right away. She says that if you look at traditional accounting, the framework is there to cover ESG-type non-financial issues. “So it’s a great puzzle to me as to why non-financial indicators should be in a separate part of the annual report, because if they matter then they should be included in the main section of the report,” she says. Others may not feel quite so strongly about ESG issues, but they definitely want there to be more discussion about non-financial performance, even if it is likely to be harder to quantify than financial indicators. There is a strong sense that the real value drivers of the business, such as intangibles, are not captured in traditional accounting.

There is no universally agreed-upon nomenclature for corporate reporting. For the purpose of this report, we refer to ‘corporate report’ as the entire collection of statements that comprise the financial report. The front-end narrative is variously called the ‘management discussion and analysis,’ ‘the directors’ report,’ and ‘the management commentary.’ In the second part of the financial report are ‘the financial statements,’ comprising a detailed summary of the financial picture for a given period of time. The financial statements are audited; in most countries, the directors’ report is not.
Two sides of the coin

Interviewees differed in their emphasis on sustainability indicators, but all agreed that the crux of the matter of new corporate reporting is the assessment of risk and opportunity. Executives see the business in these terms and so do investors. Hudson says that investors might tolerate greater risk if the opportunities were also perceived as greater. This links to the discussion of corporate strategy and the weighing of future risk and reward. “The point is not the exposure to the risk, but what is being done about it, and that comes down to strategy,” she says.

The different dimensions of corporate reporting (short-term versus long-term; backward versus forward; financial versus non-financial; directors’ report versus the financial statements) tend to converge at this point. And this revolves around the question of providing a convincing argument to investors about the sustainability of a company’s business model, based on its strategy, the risks faced and how they are managed. “At the moment, we don’t have a real reporting framework for that,” says Schindler. “In most reporting models there is a chairman’s statement and a directors’ report, but there are no parameters at the moment for there to be a story connecting the dots between strategy, risks and financial performance.”

As the world (the Western world in particular) struggles to strengthen the financial system, nowhere is this emphasis on linkage more important than for financial institutions. In a situation such as the financial meltdown of 2008, banks have an obligation to refresh their financial disclosures in the light of the risks that are emerging, Picot says. Stephen Haddrill, Chief Executive Officer of the Financial Reporting Council, agrees about the importance of risk reporting. He says that the financial crisis has underlined the importance of understanding systemic risk. “Companies need to take a hard look at whether they are passing risk to another organization, if that is what they are intending to do, and, if so, what is the strength of the counterparty. We hope that the development of risk committees, particularly in financial services, will cause people to consider these matters more carefully,” Haddrill says.

Only connect

Interviewees unanimously wanted to see improvements in governance, so that companies can communicate better, not just with investors, but with auditors and with each other inside the company. One way of doing so is to enhance the role of audit committees, says Brian Hunt, Chief Executive Officer of the Canadian Public Accountability Board, so that they are more proactive in their discussions with auditors and management, particularly in terms of assessing audit quality and understanding the audit risks facing a company. The audit committee should set the appropriate environment for the discussion between management and auditors, especially among smaller companies.

Others, such as Picot, called for more discussion between companies and investors, a point emphasized by Haddrill. “We at the FRC are keen to encourage a stronger dialogue between investors and companies, and we want to see the development of narrative reporting so that it remains of the highest possible value to investors and that companies are assisted in that, because investors want to engage on reporting and auditing matters. It has to be a two-way street,” Haddrill says. “We want to encourage investors, especially fund managers, in their stewardship role and through that dialogue with companies, to raise the quality of corporate reporting.”

The Great Depression triggered a transformation of corporate reporting. Will the Great Recession have the same effect? International Financial Reporting Standards (IFRS) have already taken us part of the way. We now have something approaching a global language for financial statements. But along with the improved comparability, there was an increase in complexity and more of a tick-the-box approach to corporate reporting. Henceforth, we need to enhance the clarity of IFRS and integrate financial reporting better with the company’s discussion of its business model, as well as its strategy and the risks it faces. There is a limit to the degree to which financial statements can convey these messages, so other parts of corporate reporting are vitally important.

The financial crisis has made the need for global harmonization and integrated reporting more urgent. New technology will, in theory, make it easier to analyze corporate reports. But in practice, it will require a concerted effort of preparers, investors, auditors, standard-setters and regulators to move corporate reporting in the desired direction.
Mervyn King is chairman of the International Integrated Reporting Council (IIRC) and a Senior Counsel and former Judge of the Supreme Court of South Africa. He serves as Chairman of the King Committee on Corporate Governance. He is Professor Extraordinaire at the University of South Africa on Corporate Citizenship; Honorary Professor at the University of Pretoria; Visiting Professor in the Rhodes Investec Business School; and has an honorary Doctor of Laws from the University of the Witwatersrand. He chaired the United Nations Committee on Governance and Oversight. He has been Chairman of the Global Reporting Initiative and is the author of Transient Caretakers (with Teodorina Lessidrenska) and The Corporate Citizen.

As chairman of the International Integrated Reporting Council (IIRC), Mervyn King is playing a central role in developing a new corporate reporting framework that integrates strategy, governance, performance and prospects over the short, medium and long-term. The council is a global coalition of regulators, investors, companies, standard-setters, the accounting profession and NGOs. Some of the interviewees in this report, such as Hans Hoogervorst of the IASB and Russell Picot of HSBC, are members of the council.

Having spent much of his career focusing on corporate governance and the role of companies in society, King has strong views on the weaknesses of the current reporting model and how it needs to change. Despite clear improvements in the quality of financial reporting, he highlights two remaining issues: the backward-looking view presented in the financial statement, and the excessive complexity of the overall corporate report, which the average user finds “incomprehensible,” he says. King employs the analogy of the automobile and the notion that the current reporting model is like “looking in the rearview mirror,” when in fact “the road ahead is very turbulent and there are huge impacts on the company, both societal and environmental.”

“We need to report in concise and comprehensible language,” King says. “While businesses will wish to communicate in this way with a wide range of stakeholder groups, integrated reporting is aimed at the company’s providers of financial capital – in short, the investors who own the business.” He believes that this improvement in the presentation and analysis of a company’s financial health will benefit the corporation internally as well as externally.

“This concise and understandable language must reflect the integrated thinking of the board. The board should demonstrate through its reporting process that it has applied its mind to the issues material to the creation of value over time, both the financial and non-financial factors. The company should show what its long-run strategic plan is and how this strategy will create future value, enabling the investor to make an informed assessment about whether the company will be able to sustain value creation in the very changed world in which we live.”
The idea is to extract material information from the detailed data the company publishes; the key point is that the information in an integrated report should be fundamental to the creation of value. So the information could relate to intellectual or human capital or be drawn from the company’s financial, governance and sustainability reports. That way, “the investor is much better informed and can allocate capital more efficiently and productively,” he says. After all, more than two-thirds of the market capitalization of companies in the S&P500 is made up of intangibles.

Look out the front, not the back

In King’s view, integrated reporting is a fundamental prerequisite for a company being able to present a forward-looking picture. “Consider a company that has done integrated thinking. First, it takes out the financial matters and compares last year’s financial performance with this year’s,” he says. “Then, it takes the other material issues crucial to the creation of value and highlights them in the integrated report and shows how one affects the other. It will show how it has embedded all this into its long-term thinking and how it will perform in today’s world. Then one can make an informed assessment about its long-term strategy and performance. In short, sustainable capitalism as opposed to short-term capitalism.”

There are three ways of organizing the information and analysis in the published corporate report, he says. One is to divide it into three sections: a narrative, a summary of the financial numbers, and more detailed statements online. The second way is what he calls “the scrambled egg,” in which the financial and non-financial reports are mixed together in one concise report and the details are made available online. The third, which King prefers, is what he calls “the octopus,” whereby “the collective mind of the board is applied to financial and non-financial information and it is all put into the octopus’s head and explained in clear language. The report [the octopus’s head] would show how material issues concerning value creation have been embedded into the board’s thinking and the company’s long-term strategy. That way, the reader can make an assessment and know exactly what was the revenue, operating profit, EPS, EBITDA, and so on. And if the reader wanted details, he or she would go online to the arms of the octopus.”

Risk management has become “absolutely critical,” King says. The IIRC has established a task force to examine the role of assurance in integrated reporting. King has strong personal views on the matter. To ascribe risk the high priority it requires, a company has to carry out what he calls a “combined assurance.” The first step is to confirm the veracity and quality of what management is reporting, he says. Second, there needs to be assurance of the quality of the internal audit, which is risk-based and is dovetailed with the external audit. All the different controls have to be in place according to the high standards set by the Institute of Internal Auditors. Third, the quality of the external audit has to be in accordance with IAASB standards. “When you do integrated thinking, it also makes you more informed about risk and you start seeing opportunities,” he says.

Beyond the next corner

King says that in his view, one of the factors that contributed to the financial crisis was “short-termism.” By contrast, “the future is sustainable capitalism. Pension funds invest based on future prospects. Integrated reporting is about accountability and transparency. To be accountable, that which one reports has to be understandable. Integrated reporting has come to the attention of the Financial Stability Board; they say that integrated reporting drives accountability. There is no doubt that reporting influences behavior,” he says. And this goes for financial institutions, specifically. "Imagine a chair with one leg and that leg is financial information; it’s very wobbly. A three-legged chair is more stable: financial information; the impact of the business model on the environment; and the impact of the business model on society. When you come to measure risk with a three-legged reporting model, you can invest more efficiently,” King says.

What role should auditors play with regard to such things as press releases and preliminary announcements? “External auditors are there to assure the annual financial statement and the highlights of the financial statement contained in the integrated report have already been assured according to the standards set by the IAASB. The issue is about future sustainability creation. For this, auditors can use the International Standard on Assurance Engagements (ISAE) 3000 standard2 being developed by International Federation of Accountants. This is a form of assurance of the accounting process used by a company and also of the reasonableness of conclusions drawn from assured facts. Assurance of an integrated report is being developed now by the IIRC and it will publish a detailed paper on the issue in the first half of 2013. It is hoped to move the assurance from a limited one to a reasonable assurance.

King does not know when integrated reporting will be in widespread use, but he is sure it is coming. “There is worldwide thinking that corporate reporting as we have known it for decades is not fit for purpose for the 21st century. We have the internet generation, radical transparency, ecological overshoot, a climate crisis, a financial crisis and higher stakeholder expectations than ever before. We cannot continue reporting such that only 1 percent reads the reports and 0.05 percent understands them;” he says. “The movement towards integrated reporting is much quicker than I thought, but I don’t know when it will be universal. The integrated reporting pilot program2 involves iconic companies like Microsoft, HSBC, Coca-Cola, and Novo Nordisk. It will be a case of follow-my-leader.”

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2 The International Integrated Reporting Council (IIRC): http://www.theiirc.org/companies-and-investors/
Hans Hoogervorst does not shy away from difficult assignments. The former Dutch finance minister took on the chairmanship of the International Accounting Standards Board (IASB) in 2011, because “the financial crisis was very much caused by faulty economic standards, faulty prudential standards or the abuse of standards and the gaming of capital requirements,” he says. “Clearly the market economy can only function well if it has a very solid set of standards and rules, and financial reporting is a very important part of that.” An example: “The insurance industry has a real problem because we have yet to provide them with a high-quality accounting standard, so transparency and comparability is somewhat limited. Whereas we have made huge steps forward in other areas, such as pension accounting.”

He readily admits finding himself in the eye of the storm. “With so many vested interests, it is an environment in which politics plays a role as well,” Hoogervorst says. In the case of accounting standards for leasing, it is very important to give investors a better view of the off-balance-sheet liabilities of companies, but there is “huge resistance” to this. “So it’s going to be a very tough battle to get it done, and during the process the pressure exerted on the IASB is quite heavy,” Hoogervorst says there is much work to be done to introduce more rigor to corporate accounts. “We don’t have very clear principles on which particular measurement method to use, and this will be one of our main challenges in the future,” he says. It’s “impossible” to come up with a precise valuation of intangibles, especially in high-tech industries. It’s hard, even, to measure income in some industries. But given the inherent problems, financial reporting has immense value for the transparency and comparability that it provides.

A decade forward

What will institutional investors want to see in a corporate report in 10 years? Obviously, there will be a very keen interest in the core of financial reporting, but their interests go much further. “They are interested in environmental, social, governance information and they would like that information to be closely knitted together,” he says. This is why IASB participates in the International Integrated Reporting Council.
To incorporate non-financial indicators into corporate reports, however, will require political decisions directing securities regulators and public authorities to tell companies what indicators to include. He would like to see environmental reporting integrated by pricing environmental externalities into the fees companies charge for different services. But he expects that social and governance information will take longer to integrate.

He agrees that more can be done to tackle so-called ‘disclosure overload’. “We do receive criticism that our standards lead to too much information and that’s why, in the context of revising the Conceptual Framework\(^3\), the IASB is trying to provide companies with clearer guidance on when disclosures are material and when they are not. The preparers themselves can do a lot to improve the readability of corporate reports. He had read one such report of a large multinational a few days before the interview, “and I was really surprised how readable it was,” he says. At the time of the interview, the IASB was planning to host a discussion forum in January 2013 bringing together preparers, auditors, securities regulators and the accounting profession to understand better how the reporting burden can be alleviated.

For Hoogervorst, necessity is the mother of invention. The continuing financial crisis provides a strong motivation to deliver improvements to the IASB’s accounting standard for financial instruments. Arguably, the most important aspect of this project is work to develop a new impairment model based on an ‘expected loss’ approach. Loan impairment is very important for banks and “you are making your best guess as to what that impairment will be,” he says. “I am firmly convinced that the incurred loss model gives too much leeway for the banking industry to engage in forbearance and not recognize the losses in time.” He feels that the IASB’s expected loss model based on a so-called ‘three-bucket’ approach\(^4\) can be applied globally. The goodwill impairment model is also faulty in that the valuation is subjective and by the time the accounts show it as being impaired, it’s usually too late. The IASB is going to review the interpretation of the impairment model to see if it makes sense.

Going global

Measuring performance is a big problem for insurance companies. The IASB has to find a way of presenting all the different elements of income in such a way that investors can understand the underwriting results as well as the fluctuations in the balance sheet. For banks, also, it is extremely important to understand what should be included in other comprehensive income (OCI). OCI is a residual category and he thinks the IASB will find a principle for OCI. The Japanese once wrote a paper for an IASB meeting defining OCI as “assets of which the value remains to be seen.” This is not a bad definition, he says.

The financial services industry will be the centre of attention for accountancy standard-setters, he believes, over the next five years. Given the budgetary situation of many industrialized nations, central banks have entered uncharted territory. “I don’t think anybody can tell with certainty what will happen, so valuing the financial industry is extremely difficult.”

As an experienced participant in international matters, Hoogervorst will have his work cut out forging a global consensus over the issues confronting the accounting profession. He says that it is time to move from the IASB maintaining evermore bilateral arrangements with national and regional standard-setters, to a multilateral forum for fostering global dialogue. He thinks this will be a better way to engage with stakeholders than occurred in the past.

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\(^3\) The Conceptual Framework sets out the concepts that underlie the preparation and presentation of IFRS-compliant financial reports. The objective of the project is to develop a comprehensive Conceptual Framework that assists the IASB in developing standards and reviewing existing ones.


\(^4\) Bucket one: “expected losses relating to a loss event expected in the next 12 months”; bucket two: “an estimate of lifetime expected losses – groups of assets”; bucket three: “an estimate of lifetime expected losses – individual financial assets.”

Russell Picot joined HSBC in 1993 and is the Group Chief Accounting Officer. He was appointed a Group General Manager in 2003. He is a director of the HSBC UK Bank Pension Trust and chairman of its Asset and Liability Committee. Prior to joining HSBC he worked for KPMG for 14 years and also undertook a secondment to the Bank of England. Picot is a member of the International Integrated Reporting Council. He holds an MA in mathematics from Cambridge University and is a Fellow of the Institute of Chartered Accountants.

As Group Chief Accounting Officer at HSBC, one of the world's largest banks, Russell Picot is in a good position to comment on the financial crisis and the role of corporate reporting. In his view, a key issue was a lack of communication between financial institutions and investors about the rapidly evolving problems the former faced in the run-up to Lehman Brothers' collapse in September 2008 and the aftermath. "We didn't see banks and institutional investors talking to each other about what risks were emerging and what information was important to the investment community," Picot says.

He believes there's been some improvement since then in communications between preparers and investors, but there is still a lot of work to be done. Following a situation such as the financial meltdown of 2008, banks have an obligation to refresh their financial disclosures in the light of the risks that are emerging, he says. "We need to create a forum where banks can talk to investors, find out what they are worried about and respond rapidly to provide them with information."

Picot is co-chair of the Enhanced Disclosure Task Force of the Financial Stability Board (the board was set up in the wake of the crisis to coordinate the work of national financial authorities). In October 2012, the task force published seven principles for enhancing the risk disclosures of banks, such as ensuring that disclosures are comprehensive and include all of the bank's key activities and risks. Picot is heartened by the fact that, within five months of inception, the task force was able to produce a report that, if adopted by banks, will help to improve the transparency of the financial system.

Investors told the task force that they were particularly interested to understand how companies control the processing of information. They wanted to see a clear description of management controls over the release of information to the financial markets. "In a world where there's a greater use of electronic media, it's increasingly important to the market that they understand the management control processes. This is one of the areas of governance that we would expect to refine over time," Picot says.

Beyond boiler plate

Like many of those interviewed for this report, Picot is critical of the quality of the risk analysis that companies publish. "It's weak right now: you get a long description and a lot of numbers, but I think there are not many good examples of disclosures showing how a company has responded to changing risks and its use of relevant metrics," he says.

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"In most cases, ticking the compliance box is something that financial reports do extremely well, but they are not conveying information in a clear and concise way."

In the financial services industry, there are two streams of reporting: the main financial reporting stream with risk information, and the growing and important stream of regulatory reporting. The latter will continue to increase in significance as new bank regulations take effect around the world. At the end of 2012, there were more than 40 major new regulations being developed and implemented worldwide. It remains to be seen whether the increase in reported data these regulations will bring actually improves the level of financial stability, however.

What is certain is that the current reporting model for all industries, not just financial services, is in need of improvement, says Picot. “In most cases, ticking the compliance box is something that financial reports do extremely well, but they are not conveying information in a clear and concise way; this view of financial reporting is held by institutional investors as well as among individual investors,” he says. He thinks we may see the evolution of a dual reporting structure: one document that is driven by the need to comply with regulations and an alternative shareholder document that is shorter than the compliance-driven report. The latter would be the one that deals with, among other things, strategic, environmental, social and governance issues. This second report would be less constrained by the regulations governing financial statements and would be an “ideal” vehicle for the sort of accounting innovations that Picot expects to occur.

He notes that the corporate governance code in the UK (where HSBC is domiciled) is trying to drive reporting in this direction. As a result, “you get drawn quickly into a discussion of integrated reporting and whether, given the challenges the world faces, we do need a broader-based, more holistic view of a company and its effect on the wider world,” says Picot.

The sustainability portion of this second report “needs to change minds internally,” he says. By laying bare its impact on society, “the company opens itself up to broader questions than simply its financial performance, and they are often uncomfortable questions, and that is a good thing.” Banks don’t manufacture things, so their impact on the world is primarily social and economic, as well as more narrowly financial. Non-financial reporting for banks “is fundamentally about preserving their reputation, which is crucial for their survival as successful businesses. The financial services industry faces very difficult times, having seen its position of trust diminish over the past five years. The very purpose of banks is now being challenged. Those challenges are very important,” he says.

Cutting clutter

The impact of the financial crisis on banks’ reputations is plain to see. Generally, banks’ market values are half their book values and credit spreads are very high. “There are issues around transparency that need to be addressed,” Picot says. “The market penalizes uncertainty and when uncertainty is sector-wide, that is a real issue for us all. People need to adapt to the mindset of doing the right thing and quickly publishing the appropriate risk information.”

For all industries over the next 10 years, Picot expects the regulators, standard-setters, preparers and users to focus on restructuring material around what’s relevant versus standard reporting. “That will require significant initiatives in a number of places around the world. Most reporting now, for a company such as HSBC, is a mixture of international accounting standards, stock exchange rules and UK and US regulations and you have to navigate all of that. So to effect this sort of change is a really major challenge.” He also expects users to have more influence over accounting standards and disclosure than hitherto. “We’ll also see a significant debate around the proper role of quarterly reporting.”

He says he is very excited about the role of voluntary approaches towards the improvement of corporate reporting standards. He cites the task force he co-chaired, as well as two UK initiatives: the Financial Reporting Council’s report “Cutting Clutter” and the FRC’s Financial Reporting Lab. But perhaps the most significant change over the next 10 years will be the increasing influence of emerging markets in all these debates. “I do believe the big emerging markets such as China are very interested in playing a major role in terms of setting the future agenda for corporate reporting,” says Picot.

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Stephen Haddrill was appointed Chief Executive Officer of the Financial Reporting Council, the UK’s independent regulator responsible for promoting high-quality corporate governance and corporate reporting. After graduating from Oxford University, he joined the Department of Energy, rising to Principal Private Secretary. He worked for the Hong Kong Government from 1990 to 1994 and then returned to the UK where he joined the Department of Trade and Industry. He later became Director General of the Association of British Insurers, before his appointment at the FRC.

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Stephen Haddrill, the chief executive officer of Britain’s Financial Reporting Council (FRC), says that corporate reporting is improving (more global consistency; better narrative reporting; a more open discussion by companies about business risks), but more needs to be done. There is too much information “dumped” into an annual report, he says. “We do need to see that clutter reduced so that the real story shines out more evidently. Too often the report is a marketing document.” Some might say this is a reasonable approach because of the competition for capital, but in Haddrill’s view, this is the wrong way to look at it: “We want the report as a whole to be fair and balanced, and signed off as such by the directors.”

If there is too much material included in the annual report, the question is, of course, what should be dropped? “One man’s dross is another’s golden nuggets,” he says. “But we have to recognize that there is a lot that’s boiler plate and repetitive, so let’s clear it out. HSBC has reduced the length of its annual report by 20 percent and this is a very good step forward. We want to ensure that consistency doesn’t lead to clutter. A lot of people want companies to make more disclosures and we will take a case-by-case approach as to how much extra information should go into corporate reports.”

Two sets of books

On financial reporting, “We have enough information, but we are concerned that the information that’s circulated internally is different from what is conveyed externally. If the management has different information, then why should this not be made available to investors?” Haddrill asks. He says that much more attention is being given by companies and investors to analysts’ briefings than to the annual report “and we need to close that gap. I would like the annual report and accounts to be seen as more useful by investors.” Investors want a more forward-looking narrative, he adds. “Reporting has at least two functions, to provide information and to contribute to the stewardship role of the board.” Knowing they are going to have to report, they need to make sure the board is doing the right things in terms of monitoring performance. This contribution to corporate stewardship is important: “We at the FRC are keen to encourage a stronger dialogue between investors and companies, and we want to see the development of narrative reporting so that it remains of the highest possible value to investors and that companies are assisted in that, because investors want to engage on reporting and auditing matters. It has to be a two-way street;”
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Haddrill says. “We want to encourage investors, especially fund managers, in their stewardship role and through that dialogue with companies, to raise the quality of corporate reporting.”

When it comes to the reporting of corporate risks, Haddrill believes that less is more: Often companies play it safe and report on the top 100 risks, so it’s important to focus on the most salient and specific risks. Even so, “a discussion of business risk is at the heart of good narrative reporting,” he says. On business controls, a global standard is unlikely. “In the US, there’s a lot of discussion about deregulating Sarbanes-Oxley (SOX), but companies did benefit from the stronger internal controls resulting from SOX in the financial crisis. In the UK, we don’t want to see a rules-based system of that nature. We are reviewing the rules around controls, but we are not going to end up with something like SOX,” Haddrill says.

Haddrill supports the aims of the integrated reporting initiative, “but we need to ensure that financial reporting is not obscured by the integration of ESG (environmental, social and governance) into the corporate report. The report and accounts should not be structured based on informing a social debate.”

Bearer of bad tidings

The financial crisis has shown that it’s important for companies to understand systemic risk. In addition, “companies need to take a hard look at whether they are passing risk to another organization, if that is what they are intending to do, and, if so, what is the strength of the counterparty. We hope that the development of risk committees, particularly in financial services, will cause people to consider these matters more carefully,” Haddrill says.

“The biggest danger in relations between a company and its shareholders is if the company has a habit of surprising them with bad news,” he says. “The banking sector is a bit different, because it fundamentally depends on public confidence. If a bank is in a state of crisis, it has to be more careful how the situation is managed. Nobody wants to bring about the failure of a bank, but equally, everybody wants investors to be well informed.”

In recent years, the role of audit committees in various industries has expanded into new areas, such as risk. “But it is important not to delegate things to the audit committee that are the responsibility of the board,” says Haddrill. “We expect the board will attest to the report and accounts as a whole being fair, balanced and understandable. Now, in taking on that responsibility on the advice of the audit committee, it is important we don’t undermine the fundamental duty of the board by leaving the impression that board committees can do the job for the board; they can’t.”
Neri Bukspan believes in making gradual changes to the corporate reporting model, not root-and-branch reform. “The salient question is whether we should now create the vehicle of the future that will be used in a different and improved fashion by investors, or strengthen our current workhorse. Given the significant lift needed, coordination among jurisdictions, standard-setters and regulators, and the precedence of other economic and regulatory priorities, I think we may have no choice but to improve on what we currently have,” he says. Having served on numerous international and national standards boards and advisory groups, he speaks with deep experience.

Why is the global accounting profession so slow to innovate? “Different people control different domains and there are many stakeholders with differing objectives and priorities, but this is not optimal. Since the system is predominantly driven by regulators, their active involvement in catalyzing the process would be essential,” he says.

“Nobody is now in the driver’s seat,” says Bukspan. “For reform to succeed, there have got to be multiple parties brought together. This is a major undertaking. It will change how the capital markets report. So that’s not easy. It would be as complex as building the next Airbus 380 from a logistics standpoint. Hence it needs to be painstakingly managed and executed.” He is not sure that the different stakeholders have the appetite for fundamental reforms, given the many other business and regulatory concerns jostling for attention. There are also high barriers to entry facing any new corporate reporting model, not to mention the need for money to fund such a project. In addition, many things that can be done may be precluded because of legal risks. “Somebody needs to assert that the benefits exceed the cost,” he says.
That said, Bukspan is not satisfied with the current reporting model. Overall, the rule-based versus principles-based systems in various countries, and the absence of a robust overarching conceptual framework, have led to a patchwork of rules and standards that cause accounting to be less and less intuitive. It’s very difficult for preparers and investors to follow, mainly due to numerous conceptual inconsistencies and variants. Many areas of accounting are also too complex, such as accounting for derivatives and hedging.

English as she is spoke

Corporate reporting provides an illusion of precision, such as when accounting for loss-contingency information, which highlights the significance to investors of the information in the notes. Consider the case of Samsung defending its patents against Apple, or the Bank of America and its mortgage litigation suits. “Depending on the stage of litigation, you don’t know what the amount will be and often it can be expressed as a range of amounts. Ultimately when a lawsuit is decided, the size of the judgment may be large or it may be zero, further emphasizing the importance of disclosures to supplement the number in the financials,” he says.

He would improve the content of corporate reports “by moving to plain English.” He has a long list of needed improvements to reports: better organization; greater use of tables and cross-referencing; greater clarity of the MD&A in the context of the financial statements information and improved disclosures. “We need to improve the information about what management thinks of the business in the context of its key performance indicators. And corporate reports should clearly explain not only what they expect in the future, but also how well companies have done compared with what they said before and why,” he says.

There is much more non-financial information needed to make the financial report really useful to investors and creditors. Take Apple’s financial statements as an example. “If you don’t put them in the context of projections of how many iPhone 5s they will sell, what relevance will the Apple financial report have?” Examples of other information that is important include: market share information; new product prospects; the emergence of new competitors; the impact of new regulatory mandates, and changes in corporate strategy or key members of management.

One issue for the future is the distinction between tangible assets versus intangibles. “The business world is becoming more and more intangible and the accounting regimes have not always treated intangibles in the same manner as tangible assets, despite many similar attributes,” he says. For example, the IASB and FASB are discussing the accounting for leasing of tangible assets, but they have set aside the discussion about a similar arrangement for intangibles. “In future, financial reporting should include a greater focus on reporting of intangibles which in many cases may be the largest profit generator.” Another prominent example is the dissimilar treatment of purchased intangibles (accounted for on a company balance sheet) versus self-developed intangibles (not recorded at all), as well as purchased versus incurred research and development costs.

Many of the changes to corporate reporting will come about as a result of digitization of the information. All the relevant information will be domiciled in an electronic domain, he says, and so the amount of information will become less important than how it is organized to make it accessible to investors. Some information will be updated more frequently than others and “the whole notion of filing with regulators could change as well,” he says. Disparate pieces of information will be linked and this will help companies tell their story better. Timeliness is also an issue. Information travels much faster than before and by the time traditional financial reports are compiled and filed, much of the financial information is dated (i.e. on average three to six months behind). As such, investors often glean a lot of information from companies’ earnings releases and other types of timely market communication. Thus, when the traditional financial statements are provided, some of the information in them is dated, or validates (through the audit) and expands upon information previously provided.

From process to product

Bukspan distinguishes between ‘report’ and ‘reporting.’ In the past, the framework was dependent on a report that was periodically printed, packaged and delivered. Reporting, by contrast, connotes a framework of continuously conveying information using electronic media, with certain elements updated more frequently than others. It will become the means of communicating with a company’s principal stakeholders. Various elements of reporting will be subject to validation and assurance in a similar manner to an audit today, he predicts.

Alongside financial reports, companies will provide information on things that are also important to investors, such as enterprise risk management, sustainability, key performance measures, management compensation, and the structure and activities of the board. It may be supplemented by an overall narrative that is periodically updated, possibly in a manner akin to the Warren Buffett letter to Berkshire Hathaway shareholders, he says. All of these will be welcome changes to the current reporting model, but for the reasons he outlined, he does not go so far as to advocate the ‘root canal’ work advocated by supporters of integrated reporting (IR), although in his view the ultimate outcome may be very similar to what IR advocates are calling for.

Although changes are slow to come, Bukspan does not write-off accounting innovation, which in his view is inevitable. The innovations that are needed must be designed to create a financial reporting system capable of meeting the information needs of 21st century investors and creditors, and of supporting evolving global capital markets for many years to come.
Christoph Hütten is Senior Vice President and Chief Accounting Officer at SAP. Hütten is responsible for SAP’s financial reporting under IFRS, including related SEC reporting, and all accounting policies, as well as the company’s Global Finance Academy. He has been with the company since 1999 and prior to SAP he was a lecturer at the Institute of Financial Accounting of Saarland University. From 2006 to 2011, Hütten served as a member of the German Accounting Standards Board and is a member and vice-chairman of the IASB’s IFRS Advisory Council.

Mark Deinert is Head of Global Controlling and an Executive Vice-President of SAP. He is responsible for all financial planning and management reporting activities as well as company-wide controlling processes. Deinert began his career at SAP Japan in 1995 and has held various positions, including project member in charge of introducing US GAAP.

As senior executives at a leading technology company, it is only natural that Christoph Hütten, Senior Vice President and Chief Accounting Officer at SAP, and Mark Deinert, the company’s Head of Global Controlling, would take a technological approach to the question of how corporate reporting will evolve in the coming years. They believe that not only corporate management, but also investors, will have a growing ability to analyze larger and larger amounts of data (one example of this kind of technology is in-memory computing). “This will enable management and investors to understand why things are the way they are. Before, the focus of corporate reporting was on the ‘what,’” Hütten says. Also, as preparers and investors rely more and more on cloud computing, this will result in a greater standardization of accounting processes, and thus may also increase the standardization of what is reported publicly.

One of the benefits of ‘big-data’ computing is the ability to gain insights into business risks by means of scenario planning, they say. But whether and how this affects external reporting on risks depends on the regulations; companies hesitate to talk publicly about risks if they may be sued. This could be overcome by safe harbors in the laws of various jurisdictions, says Deinert, but only if those harbors work effectively to protect corporate executives and companies from litigation.

Long before big data becomes an important factor in corporate reporting, Hütten and Deinert are already seeing big changes in the needs of investors. They say that the official quarterly report is becoming less and less important as the source of financial news. “To catch the news, investors tend to rely on the quarterly press release and SAP’s conference call with financial analysts the same day of the release. And they use the quarterly report as an encyclopedic source for the details,” says Hütten.

One weakness of the current corporate reporting model is the divergence between official IFRS numbers and the non-IFRS numbers based on the data used internally to manage the business. The IFRS numbers are not so useful for steering the business, and so management does not feel comfortable providing guidance on the capital markets based on IFRS numbers. “Thus, there is the challenge of reporting externally, without creating confusion, both the IFRS and...”

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the non-IFRS numbers plus reconciliations,” says Hütten. So should they converge? “Companies need to be allowed to report both the management numbers and the IFRS ones. If they were prevented from reporting the former, it would be a disaster,” he says. To avoid making things even more complex, however, the IASB should evaluate what companies exclude from their non-IFRS numbers to help prevent the differences between the two sets of numbers from growing.

Hütten and Deinert are perfectly honest about the fact that the ever-rising volume of corporate reporting is compliance-driven. Every new IASB standard requires more disclosure than its predecessor. “It’s usually more efficient for a preparer to adopt a checklist approach to disclosure rather than evaluate and document individually the materiality of each disclosure, although they may admit that only a minority of the disclosure details are truly relevant,” says Hütten.

There are two ways this may change for the better. One is that eXtensible Business Reporting Language (XBRL) will enable the investor to choose what information he or she wishes to see, thereby reducing the complexity. The other is that the IASB is developing a disclosure framework that should give individual companies more flexibility on reporting what the management thinks is most useful. Unfortunately, “these two trends completely contradict each other,” Hütten says. Does he prefer the former or the latter? “It’s like asking whether I prefer the starter or the dessert. You only eat a proper meal if you get both of them. There needs to be a certain amount of standardized disclosures to compare companies, enabled by XBRL. Then, on top of this, the additional disclosures will focus on what the management thinks is important,” he says.

They predict that there will not be three sections to the corporate report (management commentary, numbers and details) but two (management commentary and the numbers, the latter of which will include the details). The numbers will be the standardized part, in XBRL, leaving the investor to decide what data is important. The first part will provide the story and the second part will be like an encyclopedia. Nobody reads the latter from cover to cover.

One significant difficulty common among many industries is the problem of how to report corporate transactions, such as mergers. “We don’t have common standards to enable companies to come up with comparable information and what is a true and fair view of the company, post-merger/divestiture,” Deinert says. Another problem is the dilemma between (a) speed of disclosure and (b) assurance that the information is a true and fair view. The inexorable trend of demanding information faster and faster makes the dilemma more difficult to manage. Real-time audit (i.e. the auditor’s assurance on the reporting processes rather than the reporting outcome) can help here, but it is an open question whether the level of trust created by a real-time audit equals the level of trust created by a traditional type of audit, says Hütten.

What are the strengths of the current system? There is a consensus that there is a need for a set of accounting standards that must be global and high quality, says Hütten. This needs to be complemented by a harmonized enforcement of the standards, or at least an alignment among the different enforcing agencies across the world. It is important to have an external audit and a lot of effort should be put into deciding what should and should not be audited. The moment that corporate reporting enters into the realm of matters of judgment and prospects, it’s a lot more difficult for an auditor to add value, he says.

There is a trend to shift the focus away from financial information towards a combination of financial and non-financial information. There is also a need to link the different key performance indicators (SAP is participating in the IIRC pilot project), but there should be a hierarchy of information: for most companies, the top KPI continues to be a financial one. Just as with financial information, there will be standardized non-financial information and then the additional information that depicts what is truly important to that particular company.

It may seem easy to agree on such a framework, but there is a dilemma in choosing between what is standardized and what is not. “You need to achieve a balance between rules that ensure investors get the information they want to compare peer companies, and the fact that the more rules there are, the more we dilute the objective of focusing on useful disclosure,” says Hütten.

As for governance, they hoped that legislators would put more trust in supervisory boards (or their equivalent) and that the litigation environment does not heat up further. If these two things do not occur, boards would no longer have a useful role as their focus would be on (personal) risk mitigation rather than effective oversight. Supervisory Boards and their Audit Committees would, for example, be weakened if they cease to have the right to propose to shareholders the external auditor due to mandatory audit rotation.

Should audit committees have more thorough discussions with auditors? “Absolutely,” says Hütten. The former usually do not have the detailed expertise to evaluate the different accounting technicalities and lack the insight into the company’s detailed financial reporting processes, risk management processes and other control processes, he says. “They need the help of the auditor not only in terms of assuring the quality of the reporting, but also in providing advice on the process of compiling the annual report. In addition, they will benefit from the auditor’s insight into areas of improvement in the company’s risk management and internal control processes. Auditors should only audit the standardized financial information; all other factual statements from the company should be based on those numbers contained in the financial statements. Thus, the additional statements won’t need auditing, unless they directly contradict the audited results,” he says.
Joachim Schindler says there are two major weaknesses in the current corporate reporting model: there’s too much detail and it’s too backward-looking. Right now, the process of reporting is more about compliance than communication, he says: “There’s a difference between what standard-setters want and the real world.” So the current role of the corporate report is not necessarily to serve the needs of shareholders. “I am not sure preparers are necessarily interested in talking about the future. There’s a risk they may say something they will later regret.”

At the end of the day, corporate executives are interested in what moves the share price, Schindler says. If the share price is influenced by short-term aspects, preparers will have a strong incentive to present a short-term picture in corporate reports. If the stock price is influenced by long-term trends, you would see executives happy to take a long-term view. And this partly depends on the shareholder structure. If there is a large, anchor shareholder who trusts the management, then it is easier to take a long-term view. But this is a question of communication, he says. If a company is able to communicate its long-term vision convincingly, “I am sure that many investors would buy this presentation,” he says.

It boils down to a question of providing convincing information about the sustainability of the business model – the company’s strategy, the business risks and how you manage them. “At the moment, we don’t have a real reporting framework for that. In most reporting models, there is a chairman’s statement and a directors’ report, but there are no parameters at the moment for there to be a story connecting the dots between strategy, risks and financial performance,” Schindler says.

“We need the report to achieve a balance between financial and non-financial indicators and to provide a perspective of the future. This is a big challenge for executives, because pretty quickly it gets into areas of commercial sensitivity,” he says. Non-financial measurements may include: innovation (such as patents); customer relationships; employee satisfaction. A lot of the key performance indicators will have to be developed on an industry-by-industry basis. For example, in a ‘people’ business (such as a service company) where an overriding objective is to attract top talent, then things like employee satisfaction and staff turnover are important.

Cautious about risks

As for the excessive complexity of the current reporting model, “somebody needs to take pretty brave decisions in reducing the details currently in the financial statement,” he says. “There is also a role for standard-setters: both the IASB and FASB announced a project on the disclosure framework to be able to make a decision about what information is necessary and what is not. The project should
Non-financial measurements may include: innovation (such as patents); customer relationships; employee satisfaction. A lot of the key performance indicators will have to be developed on an industry-by-industry basis.

look at improving disclosures and cutting complexity.” One possible area to cut, he suggests: information about reconciliations from one period to another. In the end, the decision about what information to drop will depend on what is important for that particular industry. Property holdings, for example, are more important for a real-state company than for a bank.

It would be advantageous to provide more information about the risks a company faces. But it must go beyond boiler-plate language; for many years, German companies have had to report on risks, but it often doesn’t provide much help in deciding whether to buy a company’s stock, says Schindler. In addition, a fuller discussion of risk should be balanced with a discussion of the business opportunities. One area of risk is a discussion of ‘going concern,’ where the focus currently is the liquidity of the company. But there is not much attention paid in this regard to the question of the sustainability of the business model. “There is no question that companies should and will report more in this area, and the challenge will be to report something that is more than merely pro forma,” he says.

How should the role of assurance change? As the focus shifts from financial statements to other types of corporate statements, such as analysts’ briefings, should the latter be subject to some kind of assurance? “The main point is that any assurance needs to have a value to whomever it is provided. If this assurance provides insight and comfort to the audit committees, I am sure they will want auditors to look at it,” says Schindler.

There is evidence, he says, that often auditors are not asked to provide a lot of insights by the audit committee and the management. In cases where auditors do provide feedback, much of it is forward-looking, which is a good thing. Then there is the question of whether these insights should be provided externally as well. “We are in favor of better communication with external stakeholders. The difficulty with our current yes/no opinion is that over time the value of it has fallen in the eyes of stockholders. But the auditor should not communicate what is the responsibility of the management to report,” he says. “As long as we have clear lines of responsibility, we are in favor of expanding the auditor’s report. We have to do this. The issue is defining what more we should report.”
Julie Hudson, CFA, is a Managing Director of UBS, where she heads the Global Sustainability team, which she founded. She is co-author of a report published by UBS in June 2012, *What is “Integrated Reporting”?* The team launched publications on ‘quantifying the unquantifiable’ in 2005, water in 2006, climate change in 2007, corporate governance in 2008, ESG (environmental social and governance) integration in 2010, and integrated reporting in 2012. Hudson received a master’s in financial economics from London University and a master’s in economic regulation and competition at City University. She is currently a Visiting Business Fellow with the Smith School of Enterprise and the Environment, Oxford University.

According to Julie Hudson, integrated reporting enables the user to understand the connection between a company’s financial performance and sustainability issues, as seen through the lens of the company’s strategy. In Hudson’s view, the content that companies should include in their integrated reports would thus largely depend on their corporate strategy. Even if the financial report and the ESG report are separate, they should serve to show, in combination, how the corporate strategy is being executed and whether the company is meeting related objectives. “If you came from Mars and happened to read some corporate reports, you would probably not have a clue what they were talking about, because such reports, as they are now, often focus on small, incremental gains or losses but not on where the company is going in a broader sense. This is a product of short-termism,” says Hudson.

If the starting point for corporate reporting was a description and analysis of any given firm’s strategy, then the choice of what information to include and what to drop would be relatively easy, she says. Similarly, the role of the assurer should not need to expand in scope. Integrated reporting is not about providing more information; it’s about providing sufficient information to get to a true and fair view. However, this begs the question of how much information is sufficient from different perspectives. Some report users may feel there is core information a company should provide in its report, irrespective of its strategy. What information should every company have a statutory duty to provide to the public?

This is a tough question to answer, because of what Hudson calls “a philosophical tug of war” between different governance regimes. The most significant split in opinion over integrated reporting is not between those who are for and against it, she says. It is between the civil-code countries (such as France and Germany) and the ‘comply or explain’ countries (such as Anglo-Saxon nations, most prominently the UK). The former require companies “to fill out data for a predetermined list of metrics or KPIs.” The latter require companies to provide information that is necessary and relevant to obtain a true and fair view of the company. This is likely to make it hard to form a consensus on the future of corporate reporting, she says. But the
IASB, the independent, accounting standards-setting body of the IFRS Foundation, has a lot of experience in reconciling the two philosophical views.

**Fusing financial and non-financial information**

Hudson is categorical that financial and non-financial performance should not be separated in the corporate report. “They should be one thing,” she says. After all, if you look at mainstream financial statements, these include intangibles, such as intellectual property and the value of the brand. Nobody tries to separate them from the rest of the financial statements. By the same token, financial and non-financial indicators should be fused together; “it is meaningless to split out non-financial risk,” she says.

If you look at traditional accounting, the reporting framework already in existence could easily be used to cover ESG-type non-financial issues that are potentially material to the business, whether because they will crystallize financially or because of indirect effects that could materially change the business model. “So it’s a great puzzle to me as to why so-called non-financial indicators should be in a separate part of the annual report, because if they matter then they should be included in the main section of the report,” she says. Sometimes different stakeholders will have different priorities in terms of what information they want from a corporate report. In South Africa, for example, companies provide a lot of information about black empowerment and little on the environment which, for some firms, may turn out to have more financial impact. “The context will shape what is reported,” she says.

The internet will be “absolutely invaluable” in helping investors to understand corporate reports. The main report might provide information on the core issues, and if investors are interested in the particulars, there could be a hyperlink to other parts of the corporate website with more of the relevant details. It is extremely important for corporate reports to show how apparently disparate aspects of the company’s strategy and operations are connected. “That’s probably what’s needed most,” Hudson says. Extensible Business Reporting Language (XBRL), to display information on web pages, can certainly help connect the dots.

Integrated reports will not only help outside investors to link one piece of information with another. Insiders will also be able to see links that would otherwise be invisible to them. The 2008 credit crunch is an example of a time when the disconnectedness of information was a problem. “You can’t blame the financial crisis entirely on unintegrated reporting, but in my view it’s likely that siloed reporting did tend to reflect the siloed ways in which companies were operating,” she says.

One type of risk that investors and companies find difficult to talk about in corporate reports is ‘black swan’ risk (an extreme event that has a low probability of happening but would be very material if it did). “It would be great if we could find a better way of discussing that kind of risk,” she says. But would companies inadvertently fan investors’ fears by discussing risks too openly? Possibly, she says. “It depends on how the information is framed.” When a company discusses its strategy, it is not unreasonable to talk about the risks that may affect the strategy. Companies’ 10-K forms submitted to the US Securities and Exchange Commission all contain a section on risk, but it’s possible few people read it because they may tend to see it as boiler-plate formulation.

But it might help if risks were framed alongside the firm’s strategy, next to opportunities. “The point is not the exposure to the risk, but what is being done about it, and that comes down to strategy,” she says. Hudson believes that new ways of corporate reporting can change the business culture. If there is an accounting culture of making connections, then the connections are more likely to be made in real life. Corporate reporting reflects the business culture, so a change in reporting could change business behavior.
Brian Hunt, FCA, is Chief Executive Officer of the Canadian Public Accountability Board (CPAB), an audit regulator. He was appointed to the position in January 2009, and has been a director of the board since its inception in 2003. He was previously head of the Ontario Institute of Chartered Accountants.

People interviewed for this report tended to emphasize the value of either a backward-looking or a forward-looking appraisal in corporate reporting. Brian Hunt, the Chief Executive Officer of the Canadian Public Accountability Board (CPAB), was firmly in the latter category. “Annual financial statements in Canada appear 90 days after the end of the financial year, hence they tend to be overlooked by investors who are focused on the quarterly forecasts. The annual statements are historic, people tend to focus on forward-looking information,” he says.

“We are moving into an instant information age. Most people are focused on the next quarter, the next twelve months. That gets into whether you should have continuous disclosure. Should we change expectations to have audit firms provide assurance on the quarterlies and/or do we want assurance on the assumptions around strategy or the key risks,” says Hunt. This would certainly shift the focus of audit firms. But the question is whether audit firms would be prepared to provide assurance on forward-looking strategies and key risks.

The backward-looking focus of corporate reporting is a significant weakness of the current reporting model, in Hunt’s view. He is equally forthright about the three other main weaknesses of the current model, namely, its complexity, volume and structure – all of which are inter-related. “It is really difficult for the average investor or analyst to understand some of the accounting that goes on in the note disclosure. Then you get into the whole volume of information. Annual reports have gone from 80 pages in length ten years ago to 400 to 500 pages today. I’ve heard comments that question whether some of the notes are really required, such as, ‘If I don’t put them in, a regulator will ask why they were left out.” In terms of structure, financial statements were initially designed to bring the important business issues to the fore, but this has become lost amid the large volume of data, he says.

Telling the story

These are not the only problems with corporate reporting. To Hunt, as with Julie Hudson of UBS, corporate strategy is the most important topic in the company’s statement. “Companies are fairly guarded in what they say about corporate strategy and I think there needs to be more openness there. It would be a tremendous help to investors,” he says. “You need to understand and be comfortable that the management and the board are focused on the appropriate strategy.”

Thus, although there is too much information overall, there seems to be too little of the really important information. Risk is another area where “there is more that can be done; companies are very reluctant to get too detailed.” The key risks the industry faces should be “front and centre” in the financial statements and located similarly prominently in the section on management discussion and analysis,
Hunt says. The question, though, is how to provide more information. How exactly do audit firms give an assurance on that? “That’s a very challenging area,” he admits.

But when it comes to business controls, less information might improve matters. “I am not sure there needs to be as much focus on business controls in the annual report as there is currently,” he says. The reporting of business controls should be through a certification process that auditors are involved in.

As for the global credit crunch in 2008, the main area of weakness from an accounting standpoint was that auditors, regulators and financial institutions did not interact enough. This interaction is happening more now than in the past but further work is needed. “Is the pass-fail model for an audit appropriate for financial institutions? I would say that it’s probably not,” says Hunt. The areas that need to be re-examined are how a bank reports its accounts and how an auditor gives an assurance of those accounts.

As for integrated reporting, Hunt was concerned about any new information requirement that would be added to existing reporting requirements. He is not sure that adding more information to the corporate report is going to help investors understand the company better. Indeed, if there is already too much information in corporate reports, the question is what should be left out. Deciding what information to exclude or drop is a “dangerous” question, Hunt says. It will depend on many factors including which industry the company is in.

Govern well

Hunt is less wary about giving an opinion regarding the governance of corporate reporting. In his view, the role of audit committees should be enhanced so that they are more proactive in their discussions with auditors and management, particularly in terms of assessing audit quality and understanding the major audit risks facing a company. The audit committee should set the appropriate environment for the discussion between management and auditors, especially among smaller companies.

Audit committees should also take more responsibility for the front end of the report (the MD&A). Auditors need to get more involved in this section of the report too, especially with regard to examining the reasonableness of the assumptions.

Hunt draws lessons from the IFRS process in terms of reaching an international consensus on any changes in corporate reporting. He wonders if the lesson is about agreeing on a common standard or agreeing on how it is interpreted. Once you agree on the standard then you have to agree on the interpretation of it, and in a principles-based environment, this is just as critical as the standard itself, he says. This may add to the difficulty of reaching agreement, but it needs to happen to avoid problems further down the road.

“Companies are fairly guarded in what they say about corporate strategy and I think there needs to be more openness there. It would be a tremendous help to investors.”
Sandra Peters leads the Financial Reporting Policy team at the CFA Institute. She is responsible for tracking all financial reporting issues, including coordinating the efforts of the Corporate Disclosure Policy Council, a committee of the institute that reviews and comments on financial reporting policy initiatives worldwide. She serves as a spokesperson for the CFA Institute to financial reporting standard-setters, including the IASB, FASB, and the US Securities and Exchange Commission. She is a member of the IFRS Interpretations Committee. Before joining the CFA Institute, Peters served as vice president and corporate controller at MetLife, and previously was a partner at KPMG providing audit services primarily for insurance and financial services companies. She is a CFA Charterholder and a CPA.

At the CFA Institute, Sandra Peters discusses financial reporting issues with investors. She says that CFA members tell her “it is not necessarily the volume of information, but the lack of a comprehensive story, which is where improvements in financial reporting are needed. Investors tell us there is a lack of ‘connecting the dots’ or pulling things together to communicate a cohesive story about a company’s results.” She adds: “There may be a significant amount of information in financial reports, but we don’t find investors calling for the removal of information.”

She notes that the Great Depression led to significant improvements in corporate reporting, including the Securities Acts of 1933 and 1934 which created information from which investors could make more informed investment decisions. She contrasts this to the current environment: “It’s ironic. We are coming out of the greatest financial crisis since the Great Depression and the emphasis by many preparers and accountants is on less disclosure. While the standard-setters are considering the disclosure framework for this purpose, there hasn’t been a comprehensive post-mortem regarding the lack of understanding of risks which resulted in the financial crisis and the disclosure improvements which are necessary to protect investors.”

Better disclosure needed

Peters says that CFA members are asking what disclosure improvements there have been as a result of the recent financial crisis. “In the US, there have been some additional disclosures associated with fair value measurements and credit risks from the FASB,” she says. “As such, it’s challenging to tell our members that anything substantial has been done to respond to the financial crisis.” She points out, as an example, that the Financial Stability Board’s Enhanced Disclosure Task Force has made recommendations with respect to improving risks disclosures, but adds that preparers are not required to follow them. Peters says that CFA members ask her: “We just experienced a situation in which we didn’t have enough information about the risks and business models. How can we be discussing removing information rather than adding or improving disclosures?”
Users tell the CFA Institute they need more, not less, information that’s meaningful, Peters says. “Investors want to have the ability to see transactions all the way through financial statements. They say they need a more comprehensive presentation of financial information and a more consistent approach as to how measurements are made. Once these foundations of financial reporting are improved, they believe there can be a more effective discussion of disclosures.”

Peters says those involved in corporate financial reporting must remember that the desire and need for data is increasing. “This is true in all aspects of our lives. We’ve become used to having data at our fingertips through our smart phones. Users of financial reporting information are no different. They will continue to request additional information, as well as seek technological enhancements that can help them organize and analyze this information,” she says. “From an investor perspective, preparers need to find a better way to organize, articulate, deliver and provide access to information for investors, rather than focus on removing disclosures.”

Looking forward
The increased use of forward-looking information and of estimates of value or uncertain measures is also changing the nature of financial reporting. Peters says, “I’ve learned that investors are much more comfortable with forward-looking information and uncertain measures, especially if you give them the underlying assumptions, methods and sensitivities involved in developing these estimates, measures or information. Accountants and auditors are less comfortable with such measures, because they aren’t generally trained in valuation concepts or decision-making under uncertainty to the same degree as investment professionals.”

“Many investors are puzzled by preparer and auditor remarks that forward-looking information shouldn’t be included in financial statements,” she says. “They believe that preparers are inconsistent. On the one hand, preparers support an impairment model that includes expectations of future credit losses. On the other hand, preparers object to fair-value measurements and disclosures regarding liquidity and interest rate risks on these very same financial instruments, on the basis that they are forward-looking information. The impairment model is, in the view of investors, no less forward-looking.” Peters thinks that auditors will need more extensive training in valuation concepts. “With the increased use of forward-looking measurements and valuation techniques, auditors will need different skills to accomplish audits.”

As other types of corporate reporting, such as analyst presentations, become more important, how will this affect the responsibilities of boards and audit committees? Peters thinks there may be a move to provide greater assurance on these types of information. “Having been an auditor and preparer, I’m always surprised by the fact that many investors do not understand that the level of assurance on MD&A is not equal to the degree of assurance provided on the financial statements. Also, we think there needs to be additional assurance work on press releases, because that’s what the market reacts to.”

As it relates to auditing and corporate governance, Peters notes that when the institute surveys CFA charterholders on this topic, they say they want to hear more from the auditor directly. She explains: “Our members want more insight into the audit risks and findings, as well as the discussion with management and the audit committee.”
Conclusion and next steps

The people interviewed for this report may disagree on a number of points, but they concur that the current corporate reporting model needs to change if it is to remain useful in the 21st century. How profound the changes need to be is one of the points of debate. This much is certain, however, that good corporate reporting plays a very important function in improving the efficiency of the capital markets and in helping to restore trust in corporations.

The purpose of this report is to stimulate debate about the future of corporate reporting and to encourage members of the business community around the world to take the following actions:

• Discuss the report with colleagues, investors and other stakeholders. Find out where there is common ground and where the disagreements lie.

• Form a well-reasoned view about the future course that you and your organization would like the debate to take.

• Discuss the themes in this report with your professional associations and participate in the appropriate fora – national, regional and global.

• For preparers, consider the changes you would like to make in your own corporate reporting. What can and should be done in the short term and what will require long-term consideration?

Only by open-minded discussion and well-reasoned argument will we be able to make the needed improvements in corporate reporting. Let the debate begin.

Your KPMG adviser will be pleased to meet with you to discuss this topic.
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Publication name: The future of corporate reporting: towards a common vision
Publication number: 121448
Publication date: February 2013