Breaking the Barriers to Monitoring & Reporting of the Intangibles that Drive Enterprise Value Creation

Amy Pawlicki - Director
Business Reporting, Assurance & Advisory Services
AICPA

Comprehensive Firm Valuation Symposium
September 14, 2010
Rutgers Business School
Current Business Reporting Model

- Adopted during, and to meet the needs of, the industrial age
- Based on assumptions that profitability is driven by tangible assets such as physical plant and equipment and raw materials that are needed to produce tangible products
- Compliance-based
- One-size-fits-all model with an exclusively historical financial statement focus
- Static, paper-based, summary-level reports
Business Reporting Must Adapt to Change

- Capital must be redeployed quickly
- Technology has enabled rapid change and increased competition
- Business reporting critical to capital allocation
- Therefore, business reporting must change:
  - Forward-looking information
  - Focus on long-term value
  - Alignment of internal and external business reporting
A New (Enhanced) Model

**Business Reporting: A Changing Dynamic**

**Historical Financial Statements**
- Lagging indicators...
  - One size fits all (GAAP)
  - Ignores nonfinancial measures
  - Reports results of past decisions
  - Periodic
  - Historical
  - Cost-basis
  - Financial only
  - Statements
  - Backward-looking

**Enhanced Business Reporting**
- Leading indicators...
  - Tied to company-specific mission, vision, and values
  - Focuses on factors critical to success
  - Moves decision criteria to forefront
  - On-demand
  - Real-time/future
  - Fair value basis
  - Comprehensive
  - Custom reports and analysis
  - Forward-looking
Regulatory and Legislative Developments

- SEC Advisory Committee on Improvements to Financial Reporting (CIFiR)
- SEC 21st Century Disclosure Initiative
- SEC Interpretive Guidance on Disclosure Related to Business or Legal Developments Regarding Climate Change
- IASB Management Commentary project
- Dodd-Frank Wall Street Reform and Consumer Protection Act to increase financial industry transparency (references use of data standards)
Perceived Costs of/Barriers to Enhanced Business Reporting

- Lack of a structured reporting framework
- Compliance burden
- Competitive disadvantage
- Liability/litigation risk
- Ability to provide assurance on non-financial information
- Technological capabilities
Lack of a Structured Reporting Framework for Non-GAAP/Non-IFRS Disclosure

Common arguments

- There is no structured framework to follow for non-financial disclosure like there is for GAAP and IFRS
- Due to the diversity of non-financial disclosure, consistency & transparency of disclosure seem unattainable
- It is difficult for regulatory bodies like SEC and IASB to mandate, and since it’s not mandated, “I don’t have to do it”

Counter-arguments

- Frameworks are already being developed by groups like the Enhanced Business Reporting Consortium, the World Intellectual Capital Initiative, the Global Reporting Initiative, and potentially the International Integrated Reporting Committee
- Open-standard, voluntary guidelines can contribute to consistency and transparency of non-financial disclosures, especially when complemented by XBRL taxonomies
Compliance Burden

**Common arguments:**

- Companies are overly burdened with existing requirements for the preparation and dissemination of information

**Counter-arguments:**

- Some believe existing disclosure requirements should be ‘simplified’ to make reporting more understandable and relevant
- The point of disclosure is relevance and usefulness to decision-makers, and we know that relevant, useful information includes, but is not limited to, the financial statements and footnotes
- Companies seeking to attract funding from the markets and creditors should expect to disclose relevant information to investors and creditors (seems obvious, right?)
- Companies already use relevant information for internal decision-making, they simply need to decide what subset is appropriate for external disclosure
Competitive Disadvantage

- **Common arguments:**
  - Disclosure of key information about intangible assets, strategy, strengths & weaknesses, etc. will put a company at a competitive disadvantage

- **Counter-arguments:**
  - No one is asking companies to disclose trade secrets, but there is plenty of relevant non-financial information that is not competitively sensitive
  - Most of this information is already out there in various forms (just not in a structured, consistent manner), via press releases, management calls with analysts, websites, annual reports, etc.
Liability/Litigation Risk

Common arguments:
• Disclosure of anything beyond what is required will put a company at risk of litigation
• Safe harbors are needed to protect companies who voluntarily endeavor to be more transparent

Counter-arguments:
• Many companies today, even in the US where liability risk is more prevalent, already disclose relevant information to their stakeholders via a number of channels
• The introduction of safe harbors by regulators like the SEC seems like a step in the right direction, but in their absence, is it really advisable to expect and/or accept no progress?
Ability to Provide Assurance on Non-Financial Information

**Common arguments:**

- It is impossible to provide assurance on non-financial information:
  - How do you define materiality where the notion of “taken as a whole” loses its relevance?
  - What do you use as suitable criteria?
- Additional cost

**Counter-arguments:**

- MD&A has been disclosed for years with review-level assurance
- The AICPA Assurance Services Executive Committee Information Integrity Task Force is developing information integrity principles & criteria to complement the Trust Services system reliability principles & criteria
- Progress has been made in the area of continuous monitoring & assurance, enabling efficient coverage at the data level
Technological Capabilities

**Common arguments:**
- Systems and software programs are not readily available to handle non-financial disclosure and analysis in an efficient and/or meaningful way

**Counter-arguments:**
- The same thing was said about XBRL before the SEC mandate went into effect, but no company has been unable to submit their financial statements and notes to the SEC in XBRL format due to a lack of system or software capabilities
- Existing technology goes far beyond what is needed to make meaningful progress in this area – technology is an enabler not a barrier!!!
Conclusion

What is really standing in the way of progress in improving the relevance and transparency of corporate reporting?

• Resistance to change
• Inertia!!

Inertia is the name for the tendency of an object in motion to remain in motion, or an object at rest to remain at rest, unless acted upon by a force.