Changing Landscape of Corporate Reporting

Q: Is there a need for companies to report information that goes beyond traditional, historical financial statements?

A: Several studies show that a large portion of a company's value is not captured in the financial statements; for example, innovation capacity, quality of management, brand, customer satisfaction and reputation — much of this information lies outside of the financial statements. As a result, investors are not getting the full picture of a company's value from the financial statements alone. A study evaluating the Market Value of the S&P 500 and the percentage split of that market value between tangible (Property Plant & Equipment, marketable securities, etc.) and intangible assets (people, research and development capabilities, intellectual capital, pipeline, access to distribution channels, etc.) reveals that in 1975, more than 80% of a company's market value was reflected in its tangible assets and thus in its financial statements, whereas by 2010 tangible assets only represented 20% of a company's market value, with the remaining 80% being attributable to intangible assets. This evolution in how companies create value today is a major driver of the need for corporate reporting that integrates the disclosure of information on how companies are creating value from all forms of capital — both tangible (financial, manufactured) and intangible (intellectual, human, social and relationship and natural).

Q: What groups are involved in setting standards for corporate reporting?

A: FASB is the designated organization in the private sector in the U.S. for establishing standards of financial accounting that govern the preparation of financial reports by nongovernmental entities. FASB is the only organization in the United States with an official mandate from the SEC to set financial reporting standards, known as U.S. Generally Accepted Accounting Principles (U.S. GAAP) for public companies to follow in compliance with U.S. securities law. The International Accounting Standards Board (IASB) is the independent standard-setting body of the IFRS Foundation that develops globally accepted International Financial Reporting Standards (IFRS). Other corporate reporting standards setters are market-driven and set voluntary standards. Examples of organizations that set voluntary standards to complement traditional financial reporting include groups such as the Sustainability Accounting Standards Board (SASB) (which is U.S. based), the International Integrated Reporting Council (IIRC), the Global Reporting Initiative (GRI), the World Intellectual Capital/Assets Initiative (WICI) and the CDP (formerly the Carbon Disclosure Project) Carbon Disclosure Standards Board, among others.

Recently, the IIRC launched the Corporate Reporting Dialogue (CRD), which brings together organizations that have significant international influence on the corporate reporting landscape. By working together toward a common goal, participants aim to respond to market calls for better alignment between the multitude of frameworks in existence and reduced burden in corporate reporting.

Q: What are the differences and similarities between these groups and their respective frameworks? Are they competitive or complementary?

A: In the U.S., FASB has a mandate from the SEC to promulgate U.S. GAAP for mandatory financial reporting by public companies. By contrast, the IIRC has established an international, voluntary, principles-based framework (International <IR> Framework) for companies to follow in helping investors and other stakeholders understand how they create value in the short, medium and long term. This framework, while voluntary, lends itself well to helping companies effectively comply with the spirit of what is intended under SEC Regulation S-K for Management Discussion & Analysis (MD&A) in the U.S., and Management Commentary outside of the U.S. That being said, the application guidance in the International <IR> Framework is flexible such that companies can report under the framework through other non-regulatory channels while still referring to their report as an Integrated Report.

The other voluntary standards setters noted above essentially develop common definitions for more granular key performance indicators (KPIs) that support integrated reporting and other non-financial reporting objectives (e.g., sustainability reporting). SASB focuses on industry-specific, ESG (environmental, social and governance) related metrics for the U.S. market, WICI develops globally relevant industry-specific KPIs, CDP develops voluntary international guidelines for carbon disclosure, and GRI has developed a comprehensive framework for sustainability reporting that has been adopted by companies around the world.

Q: What is the benefit of following these voluntary reporting standards if they are not required?

A: Standardized reporting frameworks, such as U.S. GAAP, establish common definitions for financial statement and other disclosure elements that allow for better comparability and transparency of disclosures across companies. Voluntary frameworks, to the extent that they gain significant adoption and traction, can achieve the same goals for key information reported to and used by investors, creditors, customers, suppliers and other stakeholders that go beyond what is covered under traditional financial reporting frameworks (U.S. GAAP, IFRS and other country GAAP). A current example of this is demand for sustainability (environmental, social and governance) reporting.

Beyond these external benefits, companies following frameworks such as <IR> and GRI often note significant internal benefits which result from the reporting process itself; e.g., the establishment of appropriate systems, processes and controls for gathering and analyzing non-financial and/or sustainability data, a better understanding of the associated risks and opportunities in these areas and thus an improved ability to manage the business as a whole.

Q: What are the risks of following voluntary reporting standards?

A: In the U.S., many companies are reticent to disclose information on a voluntary basis for fear of creating additional liability risk. While this is a valid concern, most of the voluntary disclosure frameworks do not call for the disclosure of forecasts or projections that might put a company at risk in the event that a target is missed and an investor brings a lawsuit claiming to have relied on that information. Instead, these frameworks establish common definitions for leading indicators that can serve as the raw material to help consumers of the information perform their own analysis/modeling and make their own projections about the future value creation potential of a company.

Some companies also cite concerns related to competitive intelligence as a reason for not embracing voluntary reporting standards, but none of these voluntary frameworks call for the disclosure of trade secrets or information that is truly competitively sensitive. Instead, they simply advocate for companies to do a better job of transparently communicating how they are creating (or risking) value, which historical financial statements alone do not always effectively do as we have learned through many high profile corporate debacles such as Enron and WorldCom.

Q: How do these voluntary corporate reporting frameworks relate to mandatory financial reporting requirements?

A: These frameworks are voluntary, so companies can choose whether, and if so, how, they report this information. For example, none of the voluntary frameworks mentioned in this Q&A are required to be reported on under U.S. securities law. That being said, a company is free to choose to report under these frameworks through existing regulatory reporting channels such as Management Discussion and Analysis (MD&A), or through any other channel they might wish to use, such as analyst calls, credit applications, their corporate website, a Sustainability report, a separate Integrated Report, etc. Many companies already are tracking and, in some cases, disclosing the kind of information covered by these frameworks through different reporting channels. They just aren't doing so on a consistent basis or in a manner that provides easy access to the information to all stakeholders.

While there are no requirements to report using these voluntary frameworks, there are specific guidelines related to climate change. For SEC specific guidance refer to Commission Guidance Regarding Disclosure Related to Climate Change.

Q: Are these voluntary frameworks relevant to both public and private companies?

A: Yes, and some have argued that the disclosure of this information is even more relevant to private and small public companies who are seeking funding but do not have analyst coverage or the same kind of access to the capital markets as large public companies. This is because these frameworks, especially the <IR> framework, emphasize disclosures that help illustrate the value creation potential of the company in the short, medium and long term, which can help companies with strong prospects to attract capital. Several years ago, the AICPA published an enhanced business reporting framework for private companies to consider in reporting to creditors. The AICPA currently is in the process of reviewing this framework to ensure that it still reflects the information creditors are using in lending decisions so that it can continue to serve as an effective tool in supporting private companies that are embracing the principles of <IR>.

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