

Reforming reporting with nonfinancials

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It's commonplace wisdom that financial reporting is rich in detail and poor on clarity. Above all, it seems geared to outmoded priorities and procedures. The accounting profession in the U.S.A. has produced the staggering quantity of around 5,000 pages of accounting rules. However, as KPMG partner Bob Elliott points out: 'At best, today's financial statements are an obsolete product.' In actual fact, the accounts published focus on the assets of the industrial age: inventory, machinery, buildings etc.

'Accountants are blind to the assets that really matter,' contends Simon Caulkin in *The Observer*. There have in fact been vociferous protests that the accounting profession has continued to ignore nonfinancials and play down their importance. The logic behind it is indeed: if you can't count it, it doesn't count.

The question being: Who can explain why Microsoft's market cap far exceeds book value and has at times been larger than that of the U.S. Big Three auto manufacturers added together? The company's fixed assets are insignificant. But the Microsoft brand is trusted and feared across the world, its intellectual capital is immense, its business strategies highly effective. And, last but not least, the Gates foundation spends more money on good causes than any other foundation.

Those reading the company's annual reports are none the wiser as to its fortes. Microsoft presents a series of catchwords on integrated innovation, responsiveness to customers and intellectual property without specifying or indeed quantifying major assets. The world's leading software producer's 10-K Note on Intangible Assets is a

typically formal statement primarily addressing acquisitions. On the other hand, its Global Corporate Citizenship Report is a lot more specific, concentrating on issues like Internet safety and digital inclusion that are close to its core business. Despite this, nonfinancials play an insignificant role in the company's reporting.

Microsoft is no exception. Most companies fail to address the N question. SAP, a world leader in business process software, has a more systematic approach to reporting nonfinancials than Microsoft. It provides relatively good insights into its innovation track record and customer service, while however failing to focus on the business environment or its intellectual capital. Beyond this, the German software producer has published various Innovation and Employee reports, giving an excellent overview of know-how exchange, personnel development etc. But the fact remains that the reporting of

two of the world's best IT companies hasn't kept pace with performance; both Microsoft and SAP fail to communicate their true value.

Most reports, whether annual or quarterly, consist of an array of tables and notes, embellished by mundane commentary that rarely provides insights into the figures. Management Discussions & Analyses (MD&As) or Operating and Financial Reviews (OFRs) seldom give investors a coherent interpretation of the previous year, let alone a clear outlook to the coming year. Investor Relations presentations, often published on web sites, put the company's equity story across a lot more eloquently than conventional reporting does. However, they tend to be equally deficient on nonfinancials.

Dissatisfaction with the current state of financial reporting is increasingly expressed by investors. Anita Skipper, Head of Corporate Governance at Morley Fund

Management, has been quoted as saying: 'A traditional financial report doesn't necessarily tell you about a company's culture, its research and development, its brands, how it treats its employees and its customers. We want to know as much as possible about these issues because they can be just as important to the future health of a company.'

Despite this pressure, it would be naïve to assume that accounting procedures are going to change radically. Accounting needs continuity; financial reports have to be comparable over long periods of time. Trying to introduce quantifications nonfinancials into financial statements is difficult at best. Valuing nonfinancial assets for instance is like squaring a circle and has failed so far. A prime example is Skandia. It pioneered the concept of Intellectual Capital (IC) in the mid 1990s, publishing a series of supplements to its annual reports. This was an intellectually stimulating

attempt to pin down intangible assets like human capital, structural capital and customer capital. However, Skandia faced the same problem that the Balanced Scorecard has been confronted with: it was trying to harmonise indicators that don't fit together. Beyond this, Skandia's scope was too narrow: it considered intellectual capital to account for the entire difference between book value and market cap, whereas the kinds of know-how, skills and potentials covered by IC only account for a part of the gap.

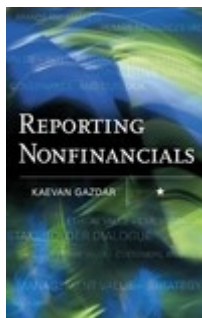
Nonfinancials are the Overheads of the 21st century; the major challenge facing corporate management is how to grasp their importance, define their parameters and report on them on an ongoing basis. The question being: how can today's value drivers be reflected in corporate reporting? The accent should indeed be on reporting, not on accounting. However, as in accounting, reporting nonfinancials only makes sense if a long-term view is

taken. No-one would dream of disclosing ROI or EVA once and never again. Similarly, brand value, employee loyalty, customer satisfaction, social

rating and many other indicators only make sense if they are consistently measured and reported on.

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