



17

Scope of External
Reporting

Scope of External Reporting

17

LEARNING OUTCOMES

After studying this chapter students should be able to:

- ▶ describe pressures for extending the scope and quality of external reports to include prospective and non-financial matters, and narrative reporting generally;
- ▶ explain how financial information concerning the interaction of a business with society and the natural environment can be communicated in the published accounts;
- ▶ discuss social and environmental issues which are likely to be most important to stakeholders in an organisation;
- ▶ explain the process of measuring, recording and disclosing the effects of exchanges between a business and society – human resource accounting.

17.1 Introduction

This chapter covers discusses the current pressures that exist to extend the scope and quality of annual reports. 17.2 includes discussion of user needs in the context of a increased volume of reporting, the need for forecast information, the effect of accounting scandals and the move towards corporate social reporting. Section 17.3 covers the IASB moves to extend narrative reporting, with the management commentary. The section also looks at the example set in the UK with the Operating and Financial Review (OFR) and the Business Review and looks at their current status. Section 17.4 examines social accounting and reporting as a general introduction to later sections in the chapter. Section 17.5 looks at accounting for the impacts of the entity on the natural environment. Section 17.6 examines various aspects of human resource accounting, including intellectual capital reporting, and human asset accounting. Section 17.7 looks at the Global Reporting Initiative.

17.2 The pressure to extend external reporting

The annual reports of entities have never been more complex and comprehensive. Despite, or perhaps partly because of, the growth in disclosure that has taken place in recent years, there

seems to be an increasing need for different approaches to disclosure of information. Part of the problem lies in a fundamental inconsistency between the overall objective of financial statements and the type of information that has traditionally been provided. The IASB's Framework states that the objective of financial statements is 'to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions'. However, financial statements, by their very nature, tend to be backward looking in that they report on transactions that have already taken place. In order to be able to make economic decisions, users may feel that they need information that has an orientation towards the future. This may be provided to a limited extent by the historical information reported in the financial statements: for example, a business that has always turned in a steady profit may perhaps be relied upon to do so again in the future.

17.2.1 Inclusion of forecasts in annual reports

Ideally, perhaps, users would like to see the inclusion of quantified forecast information as part of the annual report. However, the provision of such information is likely to be unacceptable to the management of commercial entities. If a business were to include an optimistic forecast which was not subsequently met, the financial market's perception is likely to be that management is incompetent. There might very well be an adverse effect on the share price, which would hardly be of benefit to shareholders. If, on the other hand, the forecast were too pessimistic, the outcome, in this case too, might be an adverse effect on the share price, resulting in an undervaluation of the business. The sensitivity of share prices to such events is suggested by the fact that there is often an adverse reaction in the financial market where a listed entity's preliminary announcement does not meet analysts' expectations.

Two other potentially sound reasons for not including forecasts are cost and confidentiality. The provision of the already complex level of disclosures in annual reports is expensive and the inclusion of forecast information would be likely to significantly increase costs. Also, the managers of commercial entities are likely to be very reluctant to disclose commercially sensitive, quantified, information about future plans.

17.2.2 The effect of accounting scandals

Whenever there is a major accounting scandal, the usual response of regulatory authorities is to increase regulation resulting in increased levels of disclosure. For example, the Enron case in the United States has resulted in a fundamental reappraisal of regulation, and has been largely responsible for the promulgation of the Sarbanes–Oxley Act which significantly increases regulation of financial reporting and auditing. Increased regulation usually results in increased quantities of disclosure.

A related effect is that over the last decade or so, there has been an increased demand for listed entities to demonstrate good corporate governance. Although there has not, as yet, been a unified international response to this demand, many countries have taken measures to improve corporate governance via legislation or the implementation of voluntary codes of conduct. The improvements are often accompanied by increased levels of disclosure.

17.2.3 Corporate social responsibility

The original model of the corporation envisaged a relationship that subsisted principally between the entity, its management and its owners. The separation between owners and managers resulted in some tension, but this could be at least partially addressed by financial

reporting and by the imposition of external audit requirements. However, throughout the latter half of the twentieth century this model looked increasingly old-fashioned. Although some authorities continued to maintain that a corporate entity should be responsible only for increasing shareholder wealth, the idea took hold that corporate entities have 'stakeholders', a much more broadly based group of interested parties, and that they bear responsibilities towards those stakeholders.

Milton Friedman, the economist, is famous for, amongst other things, asserting the values of the old model of the corporation. In an article in 1970 ('The social responsibility of business to increase its profits', *The New York Times Magazine*), he argued as follows:

What does it mean to say that the corporate executive has a 'social responsibility' in his capacity as a businessman? If this statement is not pure rhetoric, it must mean that he is to act in some way that is not in the interest of his employers [the shareholders]. ... Insofar as his actions in accord with his 'social responsibility' reduce returns to stockholders, he is spending their money ...

The counter-arguments to Friedman's view include the following points:

- Modern corporations are so powerful that they are able to influence every aspect of community life. Power must, in a just society, be accompanied by responsibility.
- The community bears the hidden cost of many corporate activities. For example, if businesses pollute the environment they do not, unless there is some legal constraint, have to bear the cost of cleaning up. This is borne through public expenditure and is financed by general taxation. The public therefore has some right to hold corporations accountable.
- The corporate business is a legal person, but in fact this is a convenient fiction. Businesses should not be able to hide behind this fiction in order to avoid the consequences of decisions made by managers (who, obviously, are real people).
- The old-fashioned view of the corporation is too simplistic to operate successfully in a complex modern society.

17.2.4 Demands for more information

The pressure to extend the scope of reporting results in demands by stakeholders for the following types of information:

1. a general increase in narrative in financial statement;
2. an increase in the depth of commentary provided by management on both the past performance of the business and its prospects for the future;
3. more, better quality, and more consistent reporting on environmental and social issues.

In the remainder of this chapter we will look at some of the ways in which entities can, and sometimes do, provide more information to their stakeholders.

17.3 Increasing the scope of reporting

In October 2005, the IASB issued a discussion paper on 'Management commentary' (this is a term synonymous with 'Operating and financial review' in the UK or 'Management discussion and analysis' which is the term commonly used in the USA).

The likely objective of the management commentary is to assist current and potential investors in assessing the strategies adopted by the entity and the potential for achieving these strategies. The management would set out their analysis of the business, which

supplements and complements the financial statements but taking account of likely future activities. It would be intended that the management commentary be comprehensive, focusing on matters that are relevant to investors and should be understandable, neutral and balanced, comparable and reliable.

Initial indications are that the management commentary would not be included in IFRS but would have a voluntary but best practice status. The terms ‘neutral’ and ‘balanced’ are obviously less onerous than achieving fair presentation, which is what the auditor is charged with ensuring. The issue of verifiability of the information that is included in the management commentary will be a difficult one as much of what is likely to be covered will be forward looking and so not necessarily verifiable. It is intended to be ‘through the management’s eyes’ and so the term ‘balanced’ is used to reflect the fact that the commentary is unlikely to avoid some element of bias as the management is likely to have a positive outlook on their strategies.

The current status of this, and all its other projects, may be determined by accessing the IASB’s website (www.iasb.org). At the time of updating this *Learning System* the IASB is planning to issue an exposure draft in the second quarter of 2009.

In order to appreciate the content that is likely to form such a report, it is useful to look at what has been introduced in the UK, namely the Operating and Financial Review and the Business Review.

17.3.1 The Operating and Financial Review

In 1993, the Accounting Standards Board (ASB) in the UK issued a statement on a form of disclosure known as the Operating and Financial Review (OFR). An OFR is intended to set out the directors’ analysis of the business, so as to provide both an historical *and* a prospective analysis of the business as seen by senior management. The inclusion of such a review as part of entities’ annual reports was not mandatory. However, the Company Law Review in the UK proposed that all UK companies over a certain size should publish an OFR, and in 2005 a statutory instrument (a statutory instrument is an amending piece of government legislation – in this case amending existing companies’ legislation in the form of the Companies Act 1985) was published that would require listed companies to publish an OFR.

The statutory instrument was supported by detailed guidance in the form of Reporting Standard 1 *Operating and financial review* (RS1), which was issued by the ASB in May 2005. However, in November 2005 the Chancellor of the Exchequer, Gordon Brown, made a surprise announcement that the statutory instrument would be withdrawn as part of an effort to cut down on red tape affecting UK businesses. The ASB in consequence converted its RS1 in January 2006 into a Reporting Statement of Best Practice (recently updated to reflect changes in companies’ legislation in the Companies Act 2006) which altered its status from a standard with mandatory application. The key points from this statement are summarised in the section below.

Many listed companies in the UK choose to disclose the OFR information on a voluntary basis, notwithstanding the withdrawal of the change to the law.

17.3.2 The Business Review

The Companies Act 2006 introduced additional requirements in the Business Review that were brought into force for financial years beginning on or after 1 October 2007.

The Business Review has a statutory purpose, which is to inform the shareholders and help them assess how the directors have performed their duties to promote the success of the company.

The Act also requires quoted companies to provide additional disclosures in their Business Review to the extent necessary for an understanding of the development, performance and position of the business. The additional disclosures include:

- The main trends and factors likely to affect future developments and activities
- Information about employees, environmental matters and social and community issues
- Information about contractual arrangements that are central to the company's activities.

All of these provisions were originally introduced in the OFR.

17.3.3 OFR: the ASB's reporting statement of best practice

The ASB specifies that an OFR should be a balanced and comprehensive analysis, consistent with the size and complexity of the business, of:

- (a) the development and performance of the entity during the financial year;
- (b) the position of the entity at the end of the year;
- (c) the main trends and factors underlying the development, performance and position of the business of the entity during the financial year; and
- (d) the main trends and factors which are likely to affect the entity's future development, performance and position.

The OFR should be prepared so as to assist members (i.e., shareholders) to assess the strategies adopted by the entity and the potential for those strategies to succeed. It is thus capable, potentially, of addressing some of the traditional limitations of financial statements, in that it specifically examines future business developments.

The ASB sets out the following principles for the preparation of an OFR:

The OFR shall:

- (a) set out an analysis of the business through the eyes of the board of directors;
- (b) focus on matters that are relevant to the interests of members (i.e., shareholders);
- (c) have a forward-looking orientation, identifying those trends and factors relevant to the members' assessment of the current and future performance of the business and the progress towards the achievement of long-term business objectives;
- (d) complement, as well as supplement, the financial statements in order to enhance the overall corporate disclosure;
- (e) be comprehensive and understandable;
- (f) be balanced and neutral, dealing even-handedly both with good and bad aspects;
- (g) be comparable over time.

The principal disclosure requirements are as follows:

- (a) the nature of the business, including a description of the market, competitive and regulatory environment in which the entity operates, and the entity's objectives and strategies;
- (b) the development and performance of the business, both in the financial year under review and in the future;

- (c) the resources, principal risks and uncertainties, and relationships that may affect the entity's long-term value;
- (d) the position of the business including a description of the capital structure, treasury policies and objectives and liquidity of the entity, both in the financial year under review and the future.

Some more specific requirements relating to particular matters are added to this broad, general description of disclosures. The statement specifies that information should be included about:

- (a) environmental matters (including the impact of the business on the environment);
- (b) the entity's employees;
- (c) social and community issues;
- (d) persons with whom the entity has contractual or other arrangements which are essential to the business of the entity;
- (e) receipts from, and returns to, members of the entity in respect of shares held by them; and
- (f) all other matters directors consider to be relevant.

It can be seen, therefore, that a mandatory OFR would have added very materially to the disclosures of many listed businesses, and that some aspects of the disclosures (notably the environmental and social aspects) would have represented a major development in disclosure for many businesses

Advantages and drawbacks of the OFR

The advantages of including an OFR as part of the annual report are as follows:

- Such a statement is a useful summary of information that can be found in a more complex form elsewhere in the financial statements.
- It may provide genuinely useful statements of management's intended business strategy, and sufficient information to be able to assess the relative success of business strategies to date.
- It may be more likely to be read and absorbed than some other parts of the annual report.

There are, however, some potential drawbacks:

- Users may rely too heavily on the OFR, and may read it in preference to a thorough examination of the detailed figures.
- Even though there is a basic template for the OFR, these statements may vary significantly in practice and may not be readily comparable.
- OFRs currently (both in the UK and elsewhere) have the status of voluntary disclosures and so they suffer from all the general drawbacks of voluntary disclosure (e.g., they may not be prepared on an entirely consistent basis, bad news may be underplayed and so on).

17.3.4 International developments

Many entities outside the UK voluntarily include an OFR as part of their annual report.

Example 17.A

Novartis is a major multinational pharmaceuticals entity based in Switzerland. Its financial statements are prepared in accordance with IFRS, but it also includes an OFR statement in its annual report. In its 2007 annual report, the OFR runs to 31 pages. It can be accessed at the Novartis website (www.novartis.com). The content of this OFR can be summarised as follows:

Factors affecting results. This section includes commentary on competitive conditions, identification of new products and exchange rate exposures.

Critical accounting policies and estimates. This includes comments on revenue, impairment, derivative financial instruments, investments in associates, pension costs and provisions.

Results of operations. This section occupies several pages, commenting on growth, the success of product lines and income and expenses.

Several pages in the OFR contain quantitative information in the form of condensed financial statements, or expanded information about income statement and statement of financial position items. However, the OFR is dominated by narrative.

17.4 Social accounting and reporting

Reporting of non-financial issues is not a new concept. Accounting theorists for many years now have questioned the role of financial reports. Traditionally, such reports have communicated financial information resulting from transactions (denominated in money values) entered into by the firm. Such transactions relate primarily to the exchange of goods and services; they exclude recognition of human capital and the effect of the entity on the social and natural environment.

Society can be seen as a set of sub-systems with which the entity interacts. Interaction with the economic sub-system is generally fairly fully reported. However, traditional financial reports have not dealt with interactions with the following sub-systems:

1. *The natural environment.* A business uses physical resources such as coal, gas, water, air but the full cost of this usage is not reflected in the financial statements. Firms may have adverse impacts on the environment, but until recently, these effects were not recognised at all in the financial statements.
2. *The sociological environment.* The way in which firms attract human resources, and the use of those resources, has an impact on society. For example, a decision to close a large division will have an adverse impact on local society. On a global level, certain groups of consumers are likely to express preferences against those firms that exploit child labour in developing countries.

Social accounting and reporting covers both financial and non-financial aspects of reporting. It is potentially very wide-ranging in its coverage, and might encompass such matters as:

- reporting on the environmental impacts of an entity's policies;
- measuring and reporting the expected value of future obligations related to rectification of environmental damage;
- measuring and reporting on the value of human assets in an entity;
- reporting policies and measurements relating to the workforce, for example, the policy on employment of disabled people, and statistics reporting on the numbers of disabled staff employed;

- reporting on an entity's intellectual capital;
- reports on an entity's policies on ethical issues.

Note that this is not a complete list of potential social reporting issues. In this chapter we will examine two principal strands in social reporting: first, measuring and reporting the impacts of an entity's activities on the natural environment, and second, measuring, reporting and disclosing the effects of exchanges between a business and society in the form of human resources. Finally, we will look at an important current development in the field of social reporting: the Global Reporting Initiative.

17.5 Accounting for the impacts of the entity on the natural environment

Environmental accounting is an umbrella term that covers many different aspects of reporting. We can distinguish, broadly, between two aspects:

1. accounting for, and disclosing, financial information relating to the interaction of the entity with its environment;
2. providing non-financial disclosures that assist the user in determining, for example, the nature of the entity's commitment to sound environmental practice, its record on sustainable development and so on.

17.5.1 Measuring and reporting financial information relating to the environment

There is an increasing trend towards holding businesses to account for their activities in relation to environmental damage. For example, the Kyoto accord commits governments around the world to significant reductions in greenhouse gas emissions. The business sector in many countries is currently being targeted by governments to meet emissions reduction targets. These have impacts on many aspects of measurement, reporting and disclosure, and some of the principal areas are described below.

Taxation-related matters

Taxation measures relating to the environment are becoming increasingly common. In the UK, for example, some or all of the following may affect organisations:

1. *Climate change levy*: This may have the effect of encouraging businesses to improve energy efficiency and to reduce emissions of carbon dioxide.
2. *Landfill tax*: A landfill tax was introduced in 1996. This may have significant financial impacts on the profitability of those businesses that dispose of large volumes of waste.
3. *Capital allowances*: For example, there are currently 100 per cent first year allowances for capital expenditure on natural gas refuelling infrastructure.

Accounting for additional costs related to the environment

Significant costs may be incurred by, for example, house-builders who build on brown-field land that has previously been contaminated. Highly restrictive planning policies limit

the use of greenfield sites for building, and so in very densely populated areas (such as England) significant decontamination activity may be required before land can be built on.

Increasingly stringent laws may involve business entities in incurring additional costs in respect of environmental damage they have caused. Where sites are polluted by, for example, mining activities, local legislation is increasingly likely to require reinstatement.

Environmental provisions

Sometimes anticipated costs related to environmental damage require provisions. Provisions required in respect of environmental costs are no different from any other provisions, in that they must follow the requirements of IAS 37 *Provisions, contingent liabilities and contingent assets*. Students should remember the recognition rules in respect of provisions.

A provision should be recognised when:

- an entity has a present obligation (legal or constructive) as a result of a past event;
- it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation;
- a reliable estimate can be made of the amount of the obligation.

The issue of recognition of related non-current assets may occur in respect of environmental provisions, as illustrated in the following example.

Example 17.B

B has commissioned an oil rig. The rig has an estimated useful life of 8 years, and initial commissioning costs are \$80 million, all of which are incurred shortly before the year ending 31 December 20X0. B adopts a policy of straight-line depreciation and is assuming a residual value of nil in respect of the oil rig asset. Depreciation will be charged for the first time in the year ending 31 December 20X1. B is obliged to recognise decommissioning and environmental restitution costs totalling \$10 million which will occur at the end of the 8-year period. These costs are unavoidable. However, the provision carries with it a related asset, in that the oil rig gives rise to future benefits in the form of access to valuable oil resources which will be exploited over the 8-year life of the rig. The appropriate rate of discount is 10% per year.

The amount of the provision required is \$10 million, on the basis of estimated future prices 8 years from now. How will the above transactions be reflected in the entity's statement of financial position at 31 December 20X0 and 31 December 20X1?

Solution

The discounted NPV of the provision at 31 December 20X0 is \$4,670,000 (\$10m × discount factor from tables of 0.467).

At 31 December 20X0 extracts from B's statement of financial position show the following:

	\$
Non-current assets at cost	84,670,000
<i>Provisions for liabilities and charges</i>	
Provisions for decommissioning and environmental restitution costs	4,670,000

Both the original cost of the asset (\$80 million) and the discounted decommissioning and environmental costs have been capitalised. At this point the effect on the income statement is nil.

One year later, the provision is remeasured to take account of the change in the time value of money (assuming that the original estimate of \$10 million of costs is still valid). The appropriate discount factor is 0.512, giving a balance on the provision account of \$5,120,000. The increase of \$450,000 will be charged to the income statement as part of financing charges. It is sometimes referred to as 'the unwinding of the finance charge'. In 20X1, the first full year of operation of the oil rig, depreciation will be charged for the first time.

At 31 December 20X1, extracts from B's statement of financial position show the following:

	\$
Non-current assets at cost	84,670,000
Less: accumulated depreciation (1/8)	<u>10,583,750</u>
Net book value	<u>74,086,250</u>
<i>Provisions for liabilities and charges</i>	
Provision for decommissioning and environmental restitution costs	<u>5,120,000</u>

The income statement will include the depreciation charge for the year (\$10,583,750) and the unwinding of the finance charge of \$450,000.

Contingent environmental liabilities

Many industries are now facing a broad range of potential environmental liabilities. Where those liabilities fit the definition of a provision, they must, of course, be recognised in the financial statements. Some potential liabilities may not, however, meet the recognition criteria, but should nevertheless be noted as contingent liabilities.

17.5.2 Non-financial disclosures

The annual report of an entity is traditionally a vehicle for presenting financial information. However, in recent times, it has also become the medium through which an often large amount of voluntary disclosure is made to stakeholders. Many of the voluntary disclosures include environmental information. This may be no more than a few additional paragraphs on the entity's policy in respect of, say, waste disposal. However, many entities, especially those engaged in environmentally sensitive operations, make very extensive disclosures. These are often narrative in nature, but they may also contain detailed quantitative data about, for example, emissions. A very thorough example of this type of disclosure is that of the Royal Dutch/Shell business. Each year since 1997, the business has published a separate report with the purpose of illustrating the group's contribution to sustainable development. The report is published in full on the group's website at www.shell.com. At the time of updating this *Learning System* (February 2008) the 2006 *Shell Sustainability Report* was available on the website. It is extensive, including a lot of information about the group's policies and activities, and it also contains some hard data in the form of quantitative measurements of, for example:

- carbon dioxide
- methane
- other Kyoto greenhouse gases
- oil spills
- hazardous and non-hazardous waste.

Several years of comparatives are provided.

However, although the standard and volume of environmental disclosure has undoubtedly increased in recent years, the current situation is not wholly satisfactory. Problems include the following:

- Not all entities report environmental information. Some entities may report only when it suits them to do so, and even where there is annual reporting, there is no guarantee of consistency in approach.
- As the disclosures are still of a voluntary nature, there is a danger that the information is unreliable. Although environmental audit exists, there is no compulsory requirement

to have environmental statements audited, unless the disclosures fall under the remit of the financial auditor (as would be the case, for example, where provisions were made or contingent liabilities were disclosed).

- The importance of disclosure varies from one industry to another. Heavily polluting industries may be suspected of putting a positive spin on their environmental disclosures. There is, in any case, often a suspicion that such disclosures are made more for public relations reasons than with the aim of genuinely assisting stakeholders.

17.6 Accounting for, and reporting on, human resource issues

Social reporting could take many forms. It could include a ‘social income statement’ which would report social costs and benefits to different areas of society, and a social statement of financial position disclosing human assets, organisational assets, and the use of public goods, and of financial and physical assets.

One of the most important documents to be produced on the subject was *The Corporate Report*, published in the UK in 1975. This was, both for its time and ours, a radical document that advocated not only the publication of financial statements, but also of supplementary reports to serve the needs of users other than the investor group. Supplementary reports would include:

1. *Statement of corporate objectives.* The statement could take many forms, but would include objectives relating to all stakeholders.
2. *Employment report.* This would give information about the number of employees, wage rates and training.
3. *Statement of future prospects.* Although *The Corporate Report* acknowledged the difficulty of reporting about future prospects, this would provide welcome information to all types of stakeholder.
4. *Value-added reports.* This would show the development of resources throughout the entity, demonstrating the interdependency of all parties (employee, government and the providers of capital). A typical value-added statement would show a split of ‘value added’ between the various providers of resources to the business:

ABC Group: value-added statement for the year ended 31 December 20X1

	\$
Revenue	X
Less: bought-in materials and services	(X)
Value added	<u>X</u>
Applied to	
Employees	
Wages, pensions and other benefits	X
Government	
Corporation tax	X
Providers of capital	
Interest on loans	X
Dividends	X
Retained by the company for future growth and	
Capital expenditure	
Depreciation	X
Retained earnings	<u>X</u>
Total allocated funds	<u>X</u>

The provision of such information would be costly. There would be a need for independent review or audit, further adding to the cost. The incorporation of this additional information in the annual report would be truly widespread only if encapsulated in regulation.

17.6.1 Disclosures in respect of social issues

Many entities, especially larger listed entities, now include some elements of disclosure relating to social issues and human resources. As in the case of environmental reporting, this may be largely narrative in nature, but it is sometimes appended with quantitative disclosures. Taking the Shell Report as an example, the following are amongst the quantitative social disclosures made in 2006:

- fatalities
- lost time injury frequency
- reportable occupational illness frequency
- numbers of security personnel
- gender diversity
- child labour
- union membership.

17.6.2 Intellectual capital reporting

The definition of 'intellectual capital' (CIMA's *Official Terminology*) is as follows:



Knowledge which can be used to create value. Intellectual capital includes (i) *human resources*: The collective skills, experience and knowledge of employees; (ii) *intellectual assets*: Knowledge which is defined and codified such as a drawing, computer program or collection of data; and (iii) *intellectual property*: Intellectual assets which can be legally protected, such as patents or copyrights.

Interest in intellectual capital has grown in recent years, as economic activity has become more oriented towards service and knowledge based industries, by contrast with the old industrial model of industries which employed large amounts of physical capital. Entities in many major industrial sectors these days rely upon human capital to generate wealth. Where physical capital in the form of non-current tangible assets is negligible in size, entities may produce statement of financial position that show very low levels of net worth. At the same time their market capitalisation may be many times greater than book value. This can often be explained in part by out of date valuations for items such as land and buildings, but the more frequently encountered hypothesis is that the gap represents intangible assets in the form of intellectual capital.

Many entities nowadays are taking up the challenge to report their intellectual capital. Such reporting undoubtedly does represent a challenge because intellectual capital is such a nebulous concept. The Swedish insurance company, Skandia, was one of the first companies to attempt comprehensive reporting of intellectual capital. One of the readings at the end of this chapter, 'Intellectual assets: the new frontier' by Peter Atrill, charts the development of intellectual capital reporting, setting out the key features of the Skandia

approach. A more recent initiative is the Meritum Project, financed by the European Union between 1998 and 2001, which brings together academics and professionals from different countries to create a guide for companies interested in implementing intellectual capital management systems. (More information on the Meritum project can be found at www.eu-know.net/tools.)

During 2003 the UK government established a taskforce on human capital management reporting, led by Denise Kingsmill. The taskforce reported in November 2003, and the full report can be downloaded from www.accountingforpeople.gov.uk. The readings at the end of this chapter include an account by Lesley Bolton of the setting up and objectives of the taskforce.

17.6.3 Human asset accounting

One possible approach to intellectual capital reporting would be to attempt to identify the intangible components of the very large gap that exists between market capitalisation and book value in many 'people' businesses. The possibility of measuring and recognising a value for the workforce as part of the non-current assets of a business has been recognised in theory for the last 30 or 40 years. However, there are many barriers to adopting this approach. The IASB in its *Framework for the Preparation and Presentation of Financial Statements* defines an asset thus:

An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

Although it is certainly realistic to expect that human assets in the form of employees will generate economic benefits in the future, a significant problem arises in respect of control. Non-current assets are legally owned or are under the control of the entity as the result of a binding agreement (such as a lease). However, it is hard to see how, unless in conditions of slavery, human assets can be controlled in that way. It is customary to control even the most creative of employees in some way, but that control does not operate for 24 hours a day, and is, in any case, short-term. By giving and serving out notice, an employee can soon be free of the partial control that is exerted by the employer.

A further problem relates to reliable measurement. This was identified by the most recent exposure draft to amend IAS 38 *Intangible Assets*. The draft discussed the possibility of recognising the workforce as an asset. It stated: 'an entity usually has insufficient control over the expected future economic benefits arising from a team of skilled staff and from training to conclude that these items meet the definition of an asset'. It goes on to state that, even if control over the future economic benefits could be demonstrated, and even if it could be demonstrated that the workforce could meet the criteria for identification as an intangible asset, it is highly unlikely that the fair value of the workforce and related intellectual capital could be measured reliably. Therefore, the exposure draft specifically prohibited recognition of an assembled workforce as a separately intangible asset.

If the value of the workforce were to be measured, how could it be achieved? Cost-based methods are a possibility. Currently, remuneration and training costs are treated as income statement deductions. However, looked at in a different way, they could be considered as investments in the workforce, and could be capitalised as part of intangible assets. Another possibility would be a valuation based approach, which could, for example, discount a future expected cash outflow on salaries to net present value.

17.7 The Global Reporting Initiative

The Global Reporting Initiative (GRI) was launched in 1997 as a joint initiative of the US non-governmental organisation, the Coalition for Environmentally Responsible Economies (CERES) and the United Nations Environment Programme. The GRI's goal was to enhance the quality, rigour and utility of sustainability reporting. In June 2000 the GRI issued its first set of reporting guidelines. These were replaced, in 2002, by a new set of guidelines, and have now been replaced by version 3.

The new guidelines are available (at the time of writing) on the organisation's website at www.globalreporting.org. The guidelines are for voluntary use.

The GRI's intention is that reporting on economic, environmental and social performance by organisations becomes as routine and comparable as financial reporting. To this end it has created a Sustainability Reporting Framework, some details of which are given below.

The Framework sets out a series of key stages that are involved in the sustainability reporting process:

- defining report content
- defining report quality
- setting the report boundary
- profile
- disclosure on management approach
- performance indicators
- Sector supplements.

The 'Profile' stage identifies the base content that should appear in a sustainability report, which can be briefly summarized as follows:

1. *Strategy and analysis*

This section provides a strategic view of the organization's relationship to sustainability. It should include a statement from the most senior decision-maker in the organisation (typically, the CEO in a commercial organisation) which should present the overall vision and strategy of the organisation in relation to sustainability. The report should then describe the key impacts, risks and opportunities in relation to sustainability.

2. *Organisation profile*

This section should provide information on the principal brands, products and services offered, the countries in which the organisation operates, markets service, scale of the organisation (e.g., number of employees, capitalisation) and any significant changes during the reporting period.

3. *Report profile*

This section should include information on the process for defining report content (e.g., how materiality has been defined), the boundary of the report, the basis for reporting on joint ventures, subsidiaries and other related organisations, data measurement techniques, and the policy and current practice for seeking assurance on the report.

4. *Governance*

The report should describe under this heading the entity's governance arrangements, including the mandate and composition of boards and committees, processes in place to avoid conflicts of interest, internally developed statements of mission, values, codes of conduct, and stakeholder engagement.

The disclosure on management approach should report on the following aspects:

1. **Economic:** Performance, market presence and indirect economic aspects, goals, policies, and any other relevant contextual information.
2. **Environmental:** A concise disclosure should be provided on materials, energy, water, biodiversity, emissions, effluent and waste, products and services, compliance, transport and any other relevant items. Details should also be provided of policies, goals and performance.
3. **Social:** This area of the report should report under the headings of Labour Practices and Decent Work, Human Rights and Society. For each of these the report should discuss goals and performance, policies, organisational responsibility, training and awareness, monitoring and any other relevant contextual information.

Extensive guidance is also offered in respect of the choice of performance indicators.

The GRI website now contains a database of reports prepared by organizations. For example, go to the website and access the Cadbury Schweppes' Corporate and Social Responsibility Report.

This section of the chapter provides only a brief outline of the GRI reporting guidelines. As the GRI has developed, the website has expanded and it now contains a very sizeable and useful resource.

17.8 Summary

This chapter has examined the pressures that currently exist to extend the scope of reporting by business entities, including a review of some of the reasons for the movement towards corporate social reporting.

The Operating and Financial Review is a potentially very useful development that is gradually being extended from its origins in the UK and is now used by several international businesses, including some that report under international standards.

The chapter proceeded to examine the broad context of social accounting and reporting before going on to describe in some detail the features of environmental reporting. The section on accounting for human resources considered *The Corporate Report* and the various statements that it recommended, and then considered some issues in relation to social reporting, intellectual capital reporting and human asset accounting.

Finally, the last section in the chapter examined the guidelines produced by the Global Reporting Initiative, outlining the nature of the recommended disclosures.

Students should note the dynamic nature of all of the topics covered in this chapter. They should try to keep up to date with the latest developments in these areas by consulting the recommended websites and by observing recent developments via the annual reports of businesses, especially those that report internationally.



Examination questions will certainly be set that relate to the areas covered here. These could take various forms, including the following:

- Discussion questions relating to the need for social reporting in its various forms. Some awareness of current developments would often be expected.
- Questions involving analysis of financial and/or non-financial statements. These might include some commentary on, for example, the usefulness of statements prepared using the GRI guidelines.

Bibliography

This chapter contains several references to useful websites. These are collected here:

Global Reporting Initiative: www.globalreporting.org

Novartis: www.novartis.com (for an example of a group reporting under international standards that also provides an Operating and Financial Review)

Royal Dutch/Shell: www.shell.com (for an example of a group providing a comprehensive environmental and social report)

Kingsmill taskforce: go to www.berr.gov.uk then search for 'accounting for people'.

Meritum project: for subsequent developments and research resources go to ww.som.cranfield.ac.uk and search for 'Meritum' or 'intangible assets'.

Index fingers bad behaviour

**Liz Fisher, *Accountancy*, May 2003, p 58–60. © Liz Fisher.
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‘Our motives, of course, may be misconstrued by a cynical world.’ It was less than half an hour into one of the largest conferences on corporate responsibility the UK has ever seen, and the words in almost everyone’s mind had been spoken. None of the 300 or so delegates seemed particularly surprised. When you are part of a group of large organisations that are committed to telling the world as loudly as possible that you are the good guys, you should expect a degree of cynicism.

Evidence of bad behaviour

It took a couple of years of successive and violent protests at World Trade Organisation summits for large corporations to realise that they were seen as the sharp end of the ‘cancer’ of capitalism. The reasons for this are many and complicated and encompass both fact and perception. A succession of local and global accidents and incidents – Bhopal, Exxon Valdez, deforestation, the ozone layer, child labour, Twyford Down – built up into an irrefutable pile of evidence against large corporations. The proliferation of fast-food and coffee chains on our high streets, often replacing the local stores that had been put out of business when consumers chose the out-of-town supermarket experience, added to the view of large corporations as the enemy of old-fashioned values. But Hollywood, too, made its own unique contribution in the form of ‘David and Goliath’ stories such as *Erin Brokovich* and pantomime corporate super-villains such as Jonathan Price in *Tomorrow Never Dies*. The end result is that business executives are now considered some of the most untrustworthy people in the developed world – which must be a great relief to estate agents and second-hand car salesman everywhere.

To suggest that the emergence of corporate social responsibility (CSR) is the direct result of the damage caused to the reputation of large organisations is cynical in itself. But there is more than a grain of truth in the statement. Companies have recognised that the bad publicity caused by environmental and social issues can affect their reputation and even their financial performance. It is no accident that the largest oil producers in the world published some of the most comprehensive and glossy environmental and social reports.

The first index of corporate responsibility

The main aim of the London conference in March was to launch the first Corporate Responsibility Index, produced and published by Business in the Community (BITC),

a charity with 700 member companies across the globe. BITC's mantra is that its members 'commit to action and to the continual improvement of their company's impact on society.' In particular, the BITC's members 'integrate responsible business practice throughout their business, impact through collaborative action to tackle disadvantage, and inspire, innovate and lead by sharing learning and experience'.

Socially responsible efforts, though, are difficult to quantify and this has been a handicap of the BITC's since its inception. The Corporate Responsibility Index represents its answer to the – a tangible measure of how companies are tackling corporate responsibility (see box).

It is hoped that the index will also persuade more companies to consider corporate responsibility in the future. The way corporate responsibility in general and the index in particular is sold to companies, though, is rather striking. Environmental and social issues were a feature of the 'caring, sharing' 1990s and it is perhaps a reflection of the tougher economic times that this decade is more about the measurement and communication of companies' environment and social performance.

The emphasis during the conference was firmly on the economic arguments of corporate responsibility. Stephen Timms, minister for corporate social responsibility, summed up the theme in saying that 'companies in the UK are beginning to understand the business benefits of socially responsible behaviour'. Patrick Mallon of BITC echoed this sentiment: 'Senior business leaders realise more than ever that responsible business practice enhances competitiveness – if it is integrated throughout the organisation,' he said. Successive speakers at the conference repeated the theory that the way to get senior management interested in social responsibility was to emphasise the economic and business benefits. Do it because it is good for business, in other words, not because it is good for the world.

Avoiding corporate spin

This is probably a sensible approach in the sense that it is language that corporations understand. But it does little to resolve one of corporate responsibility's major handicaps – the impression that it is nothing more than corporate spin, or 'greenwash', as some environmentalists have labelled it. It is easy to be cynical when McDonald's announces as part of its corporate responsibility programme 'World Children's Day', when the doors of 100 of its restaurants are thrown open in order to raise money for children in need. True, almost \$20 million (£12.9 million) was raised for children's charities but with so much of McDonald's marketing aimed at a younger audience, amid so much concern over the dietary habits of children thanks to fast food outlets such as McDonalds, should the company be surprised at cynicism?

Supporters of corporate responsibility argue that any step towards more socially responsible behaviour has to be welcomed, whatever the motives. The index, though, does serve to highlight a number of difficulties with corporate responsibility in general. It concentrates, for instance, on the reporting of social and environmental issues and the extent to which the policies and systems are embedded within an organisation. Some of the companies in the highest quintiles of the index are, by their nature, some of those that can potentially cause great damage to the environment, while a number of media groups and companies from other seemingly benign sectors fall into the lower quintile. The fact that the largest oil companies publish comprehensive environmental and social reports does not alter the fact that drilling for oil, however 'sensitively' it is done, damages the planet and burning oil products damages the atmosphere. The fact that you are honest about something does not make it right. This presents environmental campaigners with a dilemma – social and

environmental reporting must be encouraged, as must the indexes that could highlight the companies that are more reluctant to buy on to corporate responsibility issues. But that could leave the impression that talking about it is enough.

The ultimate aim of the index, according to BITC, was to present a figure that analysts and the general public can ‘kick the tyres of’ – in other words, to provide some sort of tangible evidence that companies were attempting to tackle the issues. There is also the underlying suggestion that the index may prompt more companies to tackle environmental and social reporting in a more enthusiastic manner. There is some evidence that this index and other voluntary initiatives such as the FTSE4Good ‘ethical’ stock market index are proving more effective than previous attempts at persuasion. Fifty-three of the FTSE 100 took part in the BITC’s survey this year, although generally the UK’s record on environmental and social reporting is still poor.

Farcical or sour grapes?

That said, it was perhaps predictable that reporting of the BITC’s Corporate Responsibility Index should concentrate on the top and bottom quartiles, or the ‘good and bad’ at socially responsible reporting. There was some consternation among speakers at the BITC’s conference that the survey should be reduced to such simple terms, with one speaker saying that the reporting had ‘done BITC a disservice’. Companies featured in the lower quintiles of the index were also unhappy. Reuters told the *Financial Times* that the index was ‘meaningless’ because it did not reflect the company’s own personal form of responsible efforts. ‘To assess us in terms of global warming and solid waste is a waste of time and farcical,’ director of corporate communications Simon Walker told the newspaper.

The publicity generated by the first index suggests that it has the potential to become a force for good in that it will encourage companies and investors to look at environmental and social issues. But realistically, the index represents only the tip of a growing iceberg. The number of ethical funds and investors has increased over recent years but, in general, the City remains largely disinterested in social and environmental issues. A delegate at the BITC’s conference pointed out that he was ‘yet to see a sales-side report that has focused on corporate social responsibility’.

Analysts counter that if a company has a CSR policy that is making a difference, they need to be told about it. But, ethical investors aside, analysts are looking for financial results and if campaigners wish to concentrate on the economic case for corporate responsibility, there is little solid evidence as yet to support them. A bad environmental record can damage a company’s brand and reputation but there is little evidence to suggest that responsible actions result in a healthier bottom line – neither, the FTSE4Good index nor the Dow Jones Sustainability Index has outperformed their respective markets.

The ultimate problem is that stockmarkets – and business in general – work on the short-term view. Analysts work on short-term information and companies and executives are rewarded for short-term performance. Environmental campaigners necessarily take the long-term view. In 100 years’ time, circumstances may force their views to converge – but at what cost?

The Corporate Responsibility Index

The Corporate Responsibility Index is described as ‘the first authoritative, voluntary benchmark of responsible business practice’ and measures ‘how companies integrate responsible practices throughout their organisation in four key impact areas: environment, marketplace, workplace and community’. Unfortunately, it is as complicated as it sounds and it is

difficult to glean clear information from the results. Companies are given an overall score achieved for strategy, integration, management practice on community, environment, marketplace and workplace, as well as their performance in their choice of five out of seven 'impact' areas (from product safety to global warming). The companies are also ranked according to how well they are managing their corporate responsibility: 'A' if they are measuring and reporting progress, 'B' if they move beyond a basic commitment and 'C' if they are beginning to measure progress. The companies were then presented alphabetically in 'quintiles', according to their score.

<i>Top quintile</i>	<i>Bottom quintile</i>
3m	3l Group
AstraZeneca	Amersham
Aviva	British Sky Broadcasting
BAA	Brixton
BP	Capita Group
BT Group	Croda International
Carillion	De la Rue
Dow Chemical Company	Expro International
ISIS	Geest
J Sainsbury	GWR Group
Marks & Spencer	International Power
MmO2	Meggitt
National Grid Transco	Mersey Docks & Harbour Co
Rio Tinto	Reuters Group
Safeway	RMC Group
Scottish Power	Taylor Woodrow
Shell International	Trinity Mirror
Tesco	United Business Media
Unilever	WH Smith Group
Waste Recycling Group	WPP Group

Intellectual assets: the new frontier

Dr Peter Atrill, ACCA Students' Newsletter, December 1998. Reprinted with the kind permission of the author.

Many readers will probably not remember the mid-1970s. For fashion conscious young men, it was the time to be wearing tank tops, flared trousers and cuban-heel boots. However, it was also around this period that the economic environment started to change in a fundamental way. The mid-1970s will probably be remembered, not so much for its contribution to fashion, but as a turning point in the world economy. Since this period we have entered a new economic era.

The period from the industrial revolution up to the mid-1970s is now described as the Industrial Age. During this age, the economic environment was relatively stable and many companies obtained competitive advantage over their rivals through the use of technology. They made large investments in physical assets, such as plant and equipment, which provided the capability to mass produce standard products. Accounting techniques such as ratios, budgeting and standard costing were developed during this Industrial Age to manage the production process more efficiently.

However, since the mid-1970s, the world economy has change dramatically. Deregulation, greater competition, rapidly changing technology and the growing sophistication of information systems have resulted in a much less stable environment within which companies must operate.

This new economic era is often described as the Information Age and it demands from companies fresh thinking about how to keep ahead of their rivals. It has been argued that, increasingly, competitive advantage will be gained through exploiting the information technology fully, through developing innovative products and through generating strong customer loyalty.

The demands of the Information Age mean that companies must reconsider their priorities. Knowledge has become the critical factor in achieving success. The successful companies will be those which exploit the knowledge and abilities of its employees most effectively. Knowledge is the 'invisible' asset which will produce the innovative products, high quality service and satisfied customers necessary for success. Companies must, therefore, give priority to developing and managing the knowledge of its employees in order to create value. The growing importance of knowledge means that physical assets, such as plant and equipment, will play a less decisive role in determining success. We can see already that for companies engaged in business services, pharmaceuticals and information technology, physical assets already play a minor role. The Chief Executive of Merck has said:

A low value product can be made by anyone anywhere. When you have knowledge no one else has access to – that's dynamite. We guard our research even more carefully than our financial assets.¹

Accounting and economic change

The changes in the economy described above have important implications for accounting. Traditional accounting was developed during the Industrial Age. It records transactions with external parties, such as the purchase and sale of goods and services, and it is these external transactions which generate a price, or value, and which, in turn, provide the basis for financial reporting. Whilst traditional accounting may have served companies well during the Industrial Age, its limitations have become more apparent in the Information Age. We have seen that knowledge is now the key to success and that it is those companies which invest effectively in managing and developing the knowledge of its employees, and in developing relationships with customers, which will succeed. However, the investment in, and condition of, these 'intellectual assets' is not revealed by traditional accounting methods. It cannot tell us whether the knowledge base of the company or the strength of customer loyalty is increasing or decreasing. Thus, it is difficult to assess the current health of the company or its capacity to survive and prosper in the future.

This kind of argument, however, is not really new. Those of us who are old enough to have worn the flared trousers and tank tops referred to earlier may remember that a topic called 'human asset accounting' emerged during the early 1970s and then sank without trace a few years later.

Human asset accounting aimed to raise awareness of the value of a company's human resources by attempting to place a value on its employees and by including this value in the statement of financial position of the company. Although human asset accounting aroused some interest, the time for such an idea was not right. In the early 1970s, most companies were still enjoying a comfortable existence and the 'winds of change' had not yet ushered in the new order. At this time, the rhetoric of company chairmen concerning the vital importance of harnessing the knowledge and capabilities of employees to obtain competitive advantage had yet to become reality. This meant there was little incentive to adopt new and radical forms of financial reporting. Furthermore, the rather conservative accounting profession displayed little interest in such fanciful notions and, anyway, had more pressing problems to resolve.

Since the early 1970s, however, we have seen a growing recognition, from both inside and outside the profession, of the need to expand the boundaries of accounting. Accounting is under increasing threat from various quarters and will only survive if it embraces new

concepts and measurement models. If accounting is to be relevant to companies in the Information Age it must recognise the growing importance of the ‘intellectual assets’ which reflect the knowledge held within a company and find ways of describing their characteristics which decision makers will find useful.

Types of intellectual assets

Intellectual assets (or ‘intellectual capital’ as they are sometimes called) can be categorised in various ways. One approach is to divide intellectual assets into three main types as follows:

1. *External assets (capital)*. These include the reputation of brands and franchises and the strength of customer relationships.
2. *Internal assets (capital)*. These include patents, trademarks and information held in customer databases.
3. *Competencies*. These reflect the capabilities and skills of individuals.²

We can see that the term ‘intellectual assets’ is much broader in its scope than human asset accounting which preceded it. Although it embraces human assets (under competencies), it recognises that the knowledge and skills of individuals is not the only source of competitive advantage. According to Hope and Hope,² human assets are the mainspring of new ideas and innovation but it will be the other forms of intellectual assets which provide the systems and channels to ensure that value is created. In Figure 1, further examples of each type of intellectual asset are provided.

External asset	Internal assets	Competencies
<i>Brands</i>	<i>Intellectual property</i>	<i>People competencies</i>
Product brands	Patents	Professional experience
Service brands	Copyright	Levels of education and skills
Corporate brands	Trademarks and design rights	Training methods
	Trade secrets and know-how	Management education
Customers	<i>Infrastructure</i>	<i>Learning capability</i>
Individual customers	Processes	Knowledge sharing
Sales channels	IT systems and databases	Communities of practice
Distribution channels	Communication systems	Problem-solving capabilities
	Operating models	
	Financial structure	
Contracts	<i>Culture</i>	<i>Management capability</i>
Franchise agreements	Management philosophy	Entrepreneurship
License agreements	Recognition and rewards	Leadership
Other favourable contracts	Management structure	Growth record

Figure 1 Some elements of ‘intellectual assets’

We can see that some of the intellectual assets (e.g., intellectual property and contracts) can fall within the conventional boundaries of accounting as an external transaction will have arisen. However, these items may represent only the ‘tip of the iceberg’. The ‘invisible’ intellectual assets can often account for a much larger proportion of the value of a business.

Measuring intellectual assets

Value based approach. The challenge facing accountants is how to measure intellectual assets. One approach is to employ existing value based measures. It has been suggested that intellectual assets, when taken as a whole, is reflected in the difference between the market value of a company and the statement of financial position value of its net assets. In many cases, the

market value of a company is considerably higher than the statement of financial position figures. In the case of BP plc, for example, the market value is almost four times higher than the book values. However, there are problems with using this approach. The difference between the market value of the business and the book values of assets cannot be wholly ascribed to intellectual assets. Accounting assets, such as freehold land, may be shown at a figure in the statement of financial position which is well below their current market values. Another problem is that share prices may fluctuate from day-to-day and so may prove unreliable when assessing changes in intellectual assets over the short term.

It has been suggested that this market based approach could be more useful if, instead of taking the absolute measure of the difference between market values and statement of financial position values, we take the ratio between the two. In this way, comparisons between similar companies and across time periods would be more meaningful. Although this suggestion may be helpful, the information derived will still only provide an overall measure of intellectual assets. The separate elements of intellectual assets are not measured. What managers will often need for decision making purposes is a breakdown of the condition of, and changes in, particular types of intellectual assets held. This separability problem places real limitations on value based measures. They are likely to be of most benefit to managers when taken together with a range of other monetary and non-monetary measures.

Skandia approach

Skandia AFS is a large Swedish financial services group which recognised the significance of the gap between the market value of the business and its book value. This led Skandia to develop ways of reporting the 'hidden' intellectual assets of the business. In a supplement to the company's 1994 annual report, the first attempt was made to describe the invisible assets of the business. It was argued:

A clearer and more balanced reporting of Skandia not only makes it easier for the world around us to value our operations, it also gives us more effective instruments to better manage and develop our hidden values. And the more tangible we can make our hidden values, the better for all of us.³

Skandia has developed a model which it refers to as the Skandia Navigator. The model reflects the four key dimensions of the business and identifies the critical success factors relating to each dimension. These critical success factors are quantified in order to measure changes overtime. The Skandia Navigator is shown in Figure 2.

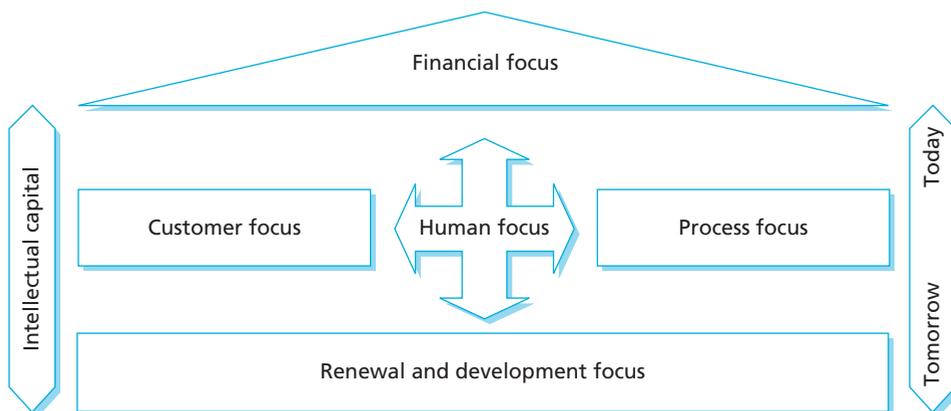


Figure 2 The Skandia Navigator.³ Skandia life assurance company limited, company report and accounts, 1994

To provide an example of the kind of measures used by the group let us consider the renewal and development focus of one of its subsidiaries, SkandiaBanken Fonder, which operates a fund management business. The key measures reflecting the critical success factors were:

- competence development expense per employee;
- employee satisfaction index (scale 1–5);
- marketing expenses/managed assets;
- marketing expense per customer.

The critical success factors will differ between businesses and must be derived through an analysis of business processes and operations.

The Skandia Navigator is an interesting approach which is closely related to the balanced scorecard approach developed by Robert Kaplan and David Norton.⁴

Intellectual capital (IC) index approach

The IC index approach attempts to provide a measure of the efficiency of intellectual assets which can be related to traditional accounting measures of efficiency. The approach recognises that a company must be efficient in transforming financial resources into intellectual assets and then, in turn, transforming its intellectual assets into financial value for shareholders.

The IC-index approach attempts to consolidate different measures for intellectual assets. To achieve this, the key measures of success must first be identified and then weighted according to their importance in order to provide a single, summary index. The choice of measures and choice of weights will again be specific to the company. In the example below, four key dimensions of the intellectual assets of a business, relationship, innovation, human and infrastructure, have been combined to obtain an IC-index score (see Figure 3).

An IC-index can be developed for each business segment as well as for the company as a whole. It is designed to be a lead indicator of changes in financial performance. Thus, a fall in the index should provide an early-warning signal of a deterioration in the financial health of the business.

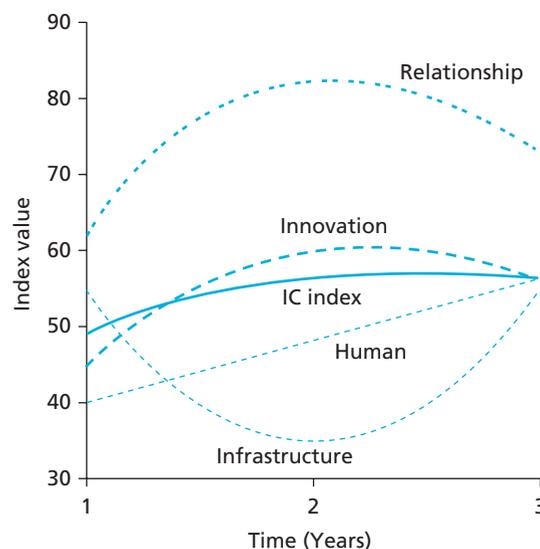


Figure 3 An example of an IC-index⁵

Summary

We have seen that, in the Information Age, knowledge has become the key to achieving competitive advantage. Successful companies will be those who can develop and manage their knowledge base effectively. In order to do this, suitable measures must be developed to provide managers with the guidance they need. This issue will take on increasing importance in future years. The value of intellectual assets will continue to rise and will represent an increasing proportion of the value of most companies. The challenge facing accountants is to contribute towards the development of intellectual asset measures. Unless we face this challenge, accountancy will become less relevant to business. Indeed, it could become as irrelevant as the tank tops and flared trousers of the mid-1970s have now become.

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Mental Arithmetic

Tony Wall, *Financial Management*, December/January 2002/03

Financial accounting professionals have spent the past decade debating how companies should report their intellectual capital (IC). Some people argue that many more of these intangible assets – beyond those associated with intellectual property such as patents – should appear on the statement of financial position, because without them shareholders aren't aware of all the elements that contribute to the overall market value of their company.

The main argument against their inclusion is that no universally acceptable method of measuring them has yet been determined. Until such an agreement is reached, these assets – generally categorised as human capital, customer capital or organisational capital (*see panel 1, below*) – could appear at randomly selected valuations, thereby distorting the picture for investors.

1 THE KEY COMPONENTS OF INTELLECTUAL CAPITAL

Human capital	Customer capital	Organisational capital
Knowledge	Customer relationships	Patents
Skills	Customer retention	Research and development
Expertise	Customer satisfaction	Copyrights
Motivation	Favourable contracts	Trademarks
Innovation	Reputation	Licences
Entrepreneurial spirit	Brand image	Processes
Leadership qualities	Sales channels	Best practices
Employee satisfaction	Distribution channels	Databases
Employee turnover	Supplier relationships	IT systems
Vocational qualifications	Business collaborations	Networking systems
Education	Franchising agreements	Management philosophy
Training	Market intelligence	Corporate culture

Other people see the debate as far too narrow and feel that a lot of work can be done on the strategic management of IC to increase the value of any company.

IC therefore cannot be ignored and, while financial accountants may have to wait for regulatory guidance before these assets can appear on the statement of financial position, it doesn't mean that the annual report can't be used as a medium for communicating how an organisation's IC is adding value. In Scandinavia – particularly Sweden – shareholders already receive a great deal of information about IC, although the reporting of such assets is more piecemeal in the rest of the developed world.

In order to gather the relevant information, financial accountants will have to rely on management accountants to capture, measure and value these assets, and to monitor any changes on a yearly basis. This, of course, will require a robust accounting system.

Although several generic frameworks for this exist, the suggested measurements will have to be adjusted to fit an organisation's particular circumstances. Proxy measurements are seen as better than no measurements at all, and there are many that can be made – for example, tracking your company's investment in training and seeing whether employee turnover decreases or productivity increases as a result of that training.

In order to see how companies in Ireland (both Northern Ireland and the Republic) have been dealing with IC, the University of Ulster conducted a survey last year. Its main aim was to see what stage they had reached when it came to measuring IC. A mixture of traditional manufacturing firms and new-economy companies – that is, those in telecoms, software, etc. – were used for the survey.

Part of the questionnaire asked the companies to rank certain elements of IC in order of importance (*see panel 2, below*). It's notable that the three most highly ranked elements represented each of the three categories of IC. These were software (organisational capital), customer satisfaction (customer capital) and workforce expertise (human capital).

2 THE HIGHEST-RANKED ELEMENTS

1	Software
2	Customer satisfaction
3	Workforce expertise
4	Brands
5	Market intelligence
6	R&D know-how
7	Mailing/phone lists
8	Distribution networks
9	Design rights
10	Licences
11	The Internet
12	Consultancy/advice
13	Manufacturing processes
14	Patents
15	Royalties

The questionnaire also attempted to determine which elements of the three categories of IC were already being measured. The most measured elements of human capital were concerned with employee loyalty – that is, length of service and staff turnover, which were both measured by more than two-thirds of the respondents. Perhaps surprisingly, the next most popular measure concerned the number of employees with professional qualifications. Although this might seem less crucial than other elements, the large proportion of respondents measuring it is probably explained by the simple fact that the information is easy to find.

Two elements that were measured by a surprisingly small number of companies were value added per employee and new ideas generated. The first finding can possibly be explained by the problems of developing an accurate method beyond simple ratio measurements such as turnover divided by the number of employees. On the other hand, there is nothing new about staff suggestion schemes. You would assume that, if a company were to have such a scheme, it would assess how well it was working.

As with some of the human capital measures, companies were not examining certain important aspects of customer capital. For example, it's hard to believe that some businesses still aren't taking note of the number of customers they have. It is also surprising that, although many respondents said customer satisfaction was important, not all of them were actually measuring it. At the same time, almost 90 per cent of the respondents were keeping track of the number of customer complaints they were receiving.

Relatively few were measuring the effectiveness of advertising campaigns, which is precisely the sort of thing that should be measured, or there is a danger that crucial marketing initiatives will be dropped during times of financial hardship.

Out of the three IC categories, organisational capital was the one that companies measured the least. Only two elements were measured by more than half of the respondents and these were both expense items: expenditure on research and development and IT spending as a percentage of administrative costs. It could be argued that these are the simplest elements to measure, because both figures would be gathered as part of the process of drafting the financial statement.

Although some companies measured the value of new ideas generated by members of staff, not all of them kept track of how many of these were actually implemented. You would expect this to be done – if for no other reason than to provide feedback to employees.

Another point of interest was the number of companies that were failing to follow up on their employee and customer satisfaction surveys. Two-thirds of the respondents were measuring employee and customer satisfaction, but fewer-than a third were monitoring any changes resulting from the feedback.

One of the most important aims of the research was to ascertain which formal systems the companies were using to evaluate their IC, having measured the various elements. Just over a third of the respondents were using no system at all. The most popular method was the balanced scorecard, which was being used by 28 percent of our sample.

Although the remaining companies listed a variety of methods by which they measured their IC – for example, key performance indicator systems, employee opinion surveys and value-chain analysis – follow-up interviews revealed that these were generally measurement systems that focused on one particular matter, such as recruitment or procurement, and were not covering all aspects of IC. Apart from those using the balanced scorecard, only one organisation seemed to be using a comprehensive measurement system, which it called a business benefit scorecard.

There is no doubt that Irish companies are highly aware of IC – most of them are already measuring certain elements of human, customer and organisational capital. But it appears that this may be occurring as part of their normal working practices and not co-ordinated within a single IC programme. The main problem seems to be that much of the work on IC is being done in isolation and is not part of an overall strategy.

Our analysis of the companies' responses indicates that there is a lack of a defined link between a working practice, the capture of information on this practice and any evaluation of it alongside data gathered from other parts of the organisation. Furthermore, although nearly all of the companies we surveyed were familiar with the term IC, only a tiny proportion

of them had people dedicated to working with it. Ireland is therefore typical of most developed nations when it comes to IC. Apart from in Scandinavia and North America, little pioneering work is being done in this area and a ‘wait and see’ strategy seems to be in place.

Accounting for people

Lesley Bolton, *Accountancy*, May 2003

Back in the 1980s, during the IT revolution, a constant chorus went up for businesses to recognise the strategic importance of computing at board level. Today a new government taskforce is looking at way to elevate ‘human capital management’ to the top of the transparency agenda and is examining how organisations can measure the quality and effectiveness of the way they manage people and how this can be reflected in the annual report.

The taskforce, which is due to present its final report in the autumn, is being led by deputy Competition Commission chairman Denise Kingsmill. Its formation follows one of the recommendations in the 2001 *Kingsmill Review into Women’s Pay and Development*, although its remit covers far more than gender issues.

‘You don’t measure the people element in the same way that you’re accustomed to measuring how many widgets you’ve got or how many contracts you’ve signed. In our enquiry we’re not looking to develop metrics in a formal way to put people in the statement of financial position, because that would be the wrong approach,’ says Kingsmill, harking back to the 1970s, when theorists dabbled with ‘human asset accounting’.

Indeed, the method of measurement is crucial if human capital is to be usefully included on the annual report. As PricewaterhouseCoopers UK board partner and taskforce member Ed Smith puts it: ‘Unless you convince people of the measurement and recognition criteria, then you will have difficulty pushing it into an external environment. I start with the business case inside an organisation. How far are companies themselves really focusing on the management of people – recruitment, retention and development – and how do they measure that at board level?’

Best practice

The taskforce’s main objective is to create best practice guidance for organisations on how they can meaningfully account for ‘human capital assets’ – as opposed to regarding them as ‘costs’. Its first job is to review existing studies and seek expert evidence from key sectors, including the corporate sector, the investment management community and academic research. ‘We want all sides of the story,’ say Smith. ‘We’re interested in hearing from cynics as well as the enthusiasts.’

Both Kingsmill and Smith emphasise that the focus is on performance indicators, which will include ‘fairness of employment’ and ‘employee satisfaction.’

‘It’s very important to keep this as a performance issue, as something which says ‘this is an indicator of good performance’ as opposed to it being a nice add-on. We wouldn’t want to slag off any environmental reporting for instance, but we see this not as an optional extra but as absolutely key to the performance of an organisation, particularly in times of full employment where there is a great deal of competition for the best people, and where retaining people is important. In the past, people management has been confined to car policies and redundancy packages and the like rather than being part of the organisation’s strategic objectives,’ says Kingsmill.

‘What gets me about glossy company reports is that you flick through the pages of smiling, happy people, then you look at the text and there’s nothing about them. You get pages and pages about the remuneration of a company’s top team, but it tells you nothing about the company’s performance. If you were a potential investor that report would give you no clue as to whether that was a company worth investing in. If there was information about how the company recruited, developed and grew their human capital, then that might be an indicator of future performance,’ she adds.

The taskforce may well find the climate right for encouraging companies to take employment practices seriously. The ICAEW has already issued a policy briefing, *Valuing Human Capital*, under which it says that ‘cultivating and measuring this ‘great intangible’ is one of the next big challenges for UK business if the UK is to remain at the forefront of the new economy.’ The subject is now the mandate of the institute’s dedicated thinktank, the Centre for Business Performance. ‘We believe there needs to be a dedicated government drive to help businesses and investors understand how human capital builds long-term corporate value and improves UK competitiveness.’

Not only that, but a new management book, *Going Off the Rails*, by John Plender, and reviewed in *Accountancy* (April, p.21) has as its central argument that we are in the midst of ‘the transition to an economy in which human and social capital are of far greater importance than physical capital’.

Directors take note.

Revision Questions

17

Question 1

You are the assistant to the finance director of MNO, a medium-sized listed entity that complies with IFRS. One of MNO's directors has proposed the publication of an Operating and Financial Review (OFR) as part of the annual financial statements. Most of the directors know very little about the OFR, and the finance director has asked you to produce a short briefing paper on the topic for their benefit.

Requirements

Write the briefing paper, which should discuss the following issues:

- any relevant regulatory requirements for an OFR;
- the purpose and, in outline, the typical content of an OFR;
- the advantages and drawbacks of publishing an OFR from the entity's point of view.

(10 marks)

Question 2

In many industries there is a large gap between the market capitalisation of listed entities and the statement of financial position value of their net assets. Some commentators have suggested that the gap comprises unrecognised intangible assets in the form of intellectual capital obtained through the employment of human resources, and that these assets should be capitalised.

Requirement

Identify the principal arguments for and against the proposal to capitalise intellectual capital.

(10 marks)

Question 3

It is becoming increasingly common for listed entities to provide non-financial disclosures intended to inform stakeholders about the business's environmental policies, impacts and practices. Supporters of such voluntary disclosures argue that stakeholders have a right to be informed above environmental issues in this way. However, there are also arguments against this type of disclosure.

Requirement

Identify and explain the principal arguments against *against* voluntary disclosures by business of their environmental policies, impacts and practices. **(10 marks)**



Question 4

The first part of this question relates to the analysis of financial statements. Students may find it useful to review Chapters 16–19 of the Learning System before attempting the question.

FW is a listed entity involved in the business of oil exploration, drilling and refining in three neighbouring countries, Aye, Bee and Cee. The business has been consistently profitable, creating high returns for its international shareholders. In recent years, however, there has been an increase in environmental lobbying in FW's three countries of operation. Two years ago, an environmental group based in Cee started lobbying the government to take action against FW for alleged destruction of valuable wildlife habitats in Cee's protected wetlands and the displacement of the local population. At the time, the directors of FW took legal advice on the basis of which they assessed the risk of liability at less than 50%. A contingent liability of \$500 million was noted in the financial statements to cover possible legal costs, compensation to displaced persons and reinstatement of the habitats, as well as fines.

FW is currently preparing its financial statements for the year ended 28 February 20X5. Recent advice from the entity's legal advisers has assessed that the risk of a successful action against FW has increased, and must now be regarded as more likely than not to occur. The board of directors has met to discuss the issue. They accept that a provision of \$500 million is required, but would like to be informed of the effects of the adjustment on certain key ratios that the entity headlines in its annual report. All of the directors are concerned about the potentially adverse effect on the share price, as FW is actively engaged in a takeover bid that would involve a substantial share exchange. Also, they feel that the public's image of the entity is likely to be damaged. The chief executive makes the following suggestion:

'Many oil businesses nowadays publish an environmental and social report, and I think it may be time for us to do so. It would give us the opportunity to set the record straight about what we do to reduce pollution, and could help to deflect some of the public attention from us over this law suit. In any case it would be a good public relations opportunity; we can use it to tell people about our equal opportunities programme. I was reading about something called the Global Reporting Initiative (GRI) the other day. I don't know much about it, but it might give us some help in structuring a report that will get the right message across. We could probably pull something together to go out with this year's annual report'.

The draft financial statements for the year ended 28 February 20X5 include the following information relevant for the calculation of key ratios. All figures are before taking into account the \$500 million provision. The provision will be charged to operating expenses.

	\$m
Net assets (before long-term loans) at 1 March 20X4	9,016
Net assets (before long-term loans) at 28 February 20X5	10,066
Long-term loans at 28 February 20X5	4,410
Share capital + reserves at 1 March 20X4	4,954
Share capital + reserves at 28 February 20X5	5,656
Revenue	20,392
Operating profit	2,080

Profit before tax	1,670
Profit for the period	1,002

The number of ordinary shares in issue throughout the years ended 29 February 20X4 and 28 February 20X5 were 6,000 million shares of 25 cents each.

FW's key financial ratios for the 20X4 financial year (calculated using the financial statements for the year ended 29 February 20X4) were:

- Return on capital employed (using average capital employed): 24.7%
- Return on assets (operating profit as a percentage of average net assets): 17.7%
- Gearing (debt as a percentage of equity): 82%
- Operating profit margin: 10.1%
- Earnings per share: 12.2 cents per share

Requirements

In your position as assistant to FW's Chief Financial Officer produce a briefing paper that:

- Analyses and interprets the effects of making the environmental provision on FW's key financial ratios. You should take into account the possible effects on the public perception of FW. **(12 marks)**
 - Identifies the advantages and disadvantages to FW of adopting the chief executive's proposal to publish an environmental and social report. **(7 marks)**
 - Describes the three principal sustainability dimensions covered by the GRI's framework of performance indicators. **(6 marks)**
- (Total marks = 25)**

? Question 5



This question relates in part to the analysis of financial statements. Students may find it useful to review Chapters 14–16 of this *Learning System* before attempting this revision question.

Recycle is a listed company which recycles toxic chemical waste products. The waste products are sent to Recycle from all around the world. You are an accountant (not employed by Recycle) who is accustomed to providing advice concerning the performance of companies, based on the data available from their published financial statements. Extracts from the financial statements of Recycle for the 2 years ended 30 September 20X7 are given below.

Recycle: income statements for the year ended 30 September

	20X7	20X6
	\$m	\$m
Revenue	3,000	2,800
Cost of sales	<u>(1,600)</u>	<u>(1,300)</u>
Gross profit	1,400	1,500
Other operating expenses	(800)	(600)
Finance costs	<u>(200)</u>	<u>(100)</u>
Profit before income tax	400	800
Income tax	<u>(150)</u>	<u>(250)</u>
Profit for the period	<u>250</u>	<u>550</u>

Recycle: statement of financial position as at 30 September

	20X7		20X6	
	\$m	\$m	\$m	\$m
<i>Assets</i>				
Tangible non-current assets		4,100		3,800
<i>Current assets</i>				
Inventories	500		350	
Trade receivables	1,000		800	
Cash in hand	<u>50</u>		<u>50</u>	
Total assets		<u>1,550</u>		<u>1,200</u>
		<u>5,650</u>		<u>5,000</u>
<i>Equity and Liabilities</i>				
<i>Capital and reserves</i>				
Called-up share capital (\$1 shares)		2,000		2,000
Retained earnings		<u>950</u>		<u>900</u>
		2,950		2,900
<i>Non-current liabilities</i>				
Interest-bearing borrowings		1,000		1,000
<i>Current liabilities</i>				
Trade payables	600		600	
Taxation payable	150		250	
Proposed dividend	200		200	
Bank overdraft	<u>750</u>		<u>50</u>	
Total equity and liabilities		<u>1,700</u>		<u>1,100</u>
		<u>5,560</u>		<u>5,000</u>

Proposed dividend is \$200 million (20X6: \$200 million).

You ascertain that depreciation of tangible non-current assets for the year ended 30 September 20X7 was \$1,200 million. Disposals of non-current assets during the year ended 30 September 20X7 were negligible.

You are approached by two individuals:

1. A is a private investor who is considering purchasing shares in Recycle. A considers that Recycle has performed well in 20X7 compared with 20X6 because revenue has risen and the dividend to shareholders has been maintained.
2. B is resident in the area immediately surrounding the premises of Recycle and is interested in the contribution made by Recycle to the general well-being of the community. B is also concerned about the potential environmental effect of the recycling of chemical waste. B is uncertain how the published financial statements of Recycle might be of assistance in addressing social and environmental matters.

Requirements

- (a) Write a report to A which analyses the financial performance of Recycle over the 2 years ended 30 September 20X7.
Assume that inflation is negligible.
Your report should refer specifically to the observations made by A concerning the performance of Recycle. **(20 marks)**
- (b) Briefly discuss whether published financial statements satisfy the information needs of B.
You should consider published financial statements *in general*, not just the extracts which are provided in this question. **(5 marks)**

(Total marks = 25)

? Question 6

You are the management accountant of Clean, an entity listed in a country that permits entities to publish financial statements in accordance with IFRS. Clean is considering seeking a listing on a US stock exchange in the near future. Your Chief Executive Officer takes a keen interest in financial reporting but he is not a professionally qualified accountant. He has recently sent you a memorandum that raises the following issue:

My political contacts tell me that government ministers are very interested in extending the practice of environmental reporting. What exactly does 'environmental reporting' mean, and to what extent is it mandatory? Why does there seem to be a trend towards greater environmental reporting? You don't need to go into massive detail, just give me an outline of what is involved.

Requirements

Draft a reply that deals with this issue. You should refer to the provisions of IFRS, and any other relevant documents where you consider them to be of assistance in supporting your reply. **(10 marks)**

? Question 7

You are the Management Accountant of Clean, an entity listed in a country that permits entities to publish financial statements in accordance with IFRS. Your Chief Executive Officer takes a keen interest in financial reporting but he is not a professionally qualified accountant. He has recently sent you a memorandum that includes the following query.

One of the phrases I often hear is 'our employees are our most important asset'. I largely agree with this sentiment, but if it is true, then surely this should be reflected in some way on the statement of financial position. I do not recall seeing such an asset in previous statement of financial position and would be most grateful for your advice.

Requirement

Draft a reply to the Chief Executive Officer's query. You should refer to the provisions of IFRS and any other relevant documents. **(10 marks)**

Solutions to Revision Questions

17

Solution 1

Briefing paper to the directors of MNO

The Operating and Financial Review

Many international entities are choosing to expand the scope of their reporting in the form of an Operating and Financial Review (OFR). There is currently no formal regulatory requirement to publish such a review. Any such publication would constitute a set of voluntary disclosures.

The principal source of guidance on the purpose and content of an OFR is the UK Accounting Standards Board (ASB) *Reporting Statement of Best Practice* which was issued in January 2006. However, this statement has no international application, except as a source of general guidance. In October 2005, the IASB issued a discussion paper on 'Management Commentary'. The topic is on the IASB's research agenda, and an Exposure Draft is expected during 2008.

The purpose of an OFR is to assist users, principally investors, in making a forward-looking assessment of the performance of the business by setting out management's analysis and discussion of the principal factors underlying the entity's performance and financial position.

Typically, an OFR would comprise some or all of the following:

- description of the business and its objectives;
- management's strategy for achieving the objectives;
- review of operations;
- commentary on the strengths and resources of the business;
- commentary about such issues as human capital, research and development activities, development of new products and services;
- financial review with discussion of treasury management, cash inflows and outflows and current liquidity levels.

The publication of such a statement would have the following advantages for MNO:

- It could be helpful in promoting the entity as progressive and as eager to communicate as fully as possible with investors.
- It could be a genuinely helpful medium of communicating the entity's plans and management's outlook on the future.

- If the IASB were to introduce a compulsory requirement for management commentary by listed entities, MNO would already have established the necessary reporting systems and practices.

However, there could be some drawbacks:

- If an OFR is to be genuinely helpful to investors, it will require a considerable input of senior management time. This could be costly, and it may be that the benefits of publishing an OFR would not outweigh the costs.
- There is a risk in publishing this type of statement that investors will read it in preference to the financial statements, and that they may therefore fail to read important information.



Solution 2

The principal arguments for the proposal are as follows:

1. Those organisations that depend upon human resources, know-how and intellectual capabilities to generate revenue, often have a relatively low level of traditional capital investment. The statement of financial position of such businesses does not reflect the true value of the capital used in revenue generation: indeed, as noted in the question, the gap between market capitalisation and the book value of net assets may be very substantial. The mismatch between statement of financial position and revenue generation could be addressed by recognising a wider range of intangible assets, including intellectual capital.
2. At present, financial statements fail to provide sufficient information to permit interested parties to assess the full range of resources available to the organisation. Their information content suffers because of low levels of intangible asset recognition.
3. It is also argued that the recognition of intellectual capital would encourage better management of human resources because it would make visible resources that have tended to be hidden and under-valued.

The principal arguments against the proposal are as follows:

1. The recognition of intellectual capital would present problems in that it does not fulfil all aspects of the definition of an asset. The Framework defines an asset as: ‘... a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow’. The problem lies in the area of control: human resources cannot be fully controlled, because staff are free to leave their employment whenever they wish.
2. The measurement of intellectual capital would present many practical difficulties. It is unlikely that the fair value of a group of employees could ever be measured reliably.
3. Recognition and measurement of such intangible factors as know-how and skills would allow for considerable latitude in practice, and it would be possible for the unscrupulous to exploit the element of judgement involved in making valuations in order to manipulate their financial statements.

Solution 3

Arguments against voluntary disclosures by businesses in respect of their environmental policies, impacts and practices might include the following principal points:

The traditional view of the corporation is that it exists solely to increase shareholder wealth. In this view business executives have no responsibility to broaden the scope or nature of their reporting as doing so reduces returns to shareholders (because there is a cost associated with additional reporting).

From a public policy perspective, if governments wish corporations and similar entities to bear the responsibility for their environmental impacts, they should legislate accordingly. In the absence of such legislation, however, businesses bear no responsibility for environmental impacts, and in consequence there is no reporting responsibility either.

Voluntary disclosures of any type are of limited usefulness because they are not readily comparable with those of other entities. Therefore, it is likely that the costs of producing such disclosures outweigh the benefits to stakeholders.

The audit of voluntary disclosures is not regulated. Even where such disclosures are audited, the scope of the audit may be relatively limited, and moreover, its scope may not be clearly laid out in the voluntary report. Voluntary reports are not necessarily, therefore, reliable from a stakeholder's point of view.

Especially where voluntary disclosures are included as part of the annual report package, there is a risk of information overload: stakeholders are less able to identify in a very lengthy report the information that is relevant and useful to them.

Voluntary disclosures by business organisations, because they are at best lightly regulated, may be treated by the organisation in a cynical fashion as public relations opportunities. The view of the business's activities could very well be biased, but it would be quite difficult for most stakeholders to detect such bias.

It is questionable whether voluntary disclosures about environmental policies, impacts and practices would meet the qualitative characteristics of useful information set out in the IASB's Framework. The key characteristics are: understandability, reliability, relevance and comparability. Voluntary environmental disclosures might well fail to meet any of these characteristics and, if this is the case, it is highly questionable whether or not they merit publication.

Solution 4

Briefing paper for the attention of the directors of FW

From: Assistant to CFO

- (a) The appendix to this paper demonstrates the effect on our key financial ratios of making the provision of \$500 million for environmental costs. The effect is substantial and is likely to make a difference to the public and market perception of the business.

The ratios before taking into account any adjustment for the provision all show significant improvements in performance during 20X5, demonstrating the strength of the business fundamentals. There is, however, a dramatic change once the provision is accounted for: compared to performance in 20X4, the post-adjustment return on equity figure has fallen by just under 2 per cent. Gearing, post-adjustment, is higher

than in 20X4. Although these are both adverse effects, the 20X5 and 20X4 numbers do not differ greatly from each other. Similarly, return on assets is lower, post-adjustment, but not by very much. Unfortunately, the effect on operating profit margin is much more noticeable. After adjusting for the provision, the ratio falls to 7.7 per cent, substantially lower than the 20X4 figure. Earnings per share is also very badly affected; the ratio, post-adjustment, drops to 8.3 cents.

The effect on public perception of our business is likely to be mostly adverse, especially once the key figure of earnings per share is absorbed by the market. However, the inclusion of the provision may prove advantageous in some respects in that we will be seen to be acting promptly and responsibly in making a provision for liabilities that have now become probable. The income statement still shows a respectable profit after all the bad news has been fully reflected and analysts may prefer to see the worst case position.

Appendix

Key financial ratios table

Ratio	20X5 ratio before provision	20X5 ratio after provision	20X4 ratio
Return on equity	31.5%	23.1%	24.7%
Return on assets	21.8%	17.0%	17.7%
Gearing	78.0%	85.5%	82.0%
Operating profit margin	10.2%	7.7%	10.1%
Earnings per share	16.7¢	8.3¢	12.2¢

Workings

1. Basis of ratio calculation

Return on equity:	$\frac{\text{Profit before tax}}{\text{Average share capital}} + \text{reserves}$
Return on assets	$\frac{\text{Operating profit}}{\text{Average net assets}}$
Gearing	$\frac{\text{Debt}}{\text{Equity}}$
Operating profit margin	$\frac{\text{Operating profit}}{\text{Revenue}}$
Earnings per share	$\frac{\text{Profit for the year}}{\text{Number of shares in issue}}$

2. Adjusting for the provision (all figures in \$ millions)

Profit before tax:	$\$1,670 - 500 = 1,170$
Closing share capital + reserves:	$\$5,656 - 500 = 5,156$
Closing net assets:	$\$10,066 - 500 = 9,566$
Operating profit:	$\$2,080 - 500 = 1,580$
Profit for the period:	$\$1,002 - 500 = 502$

3. Ratio calculations

		<i>Ratio before provision</i>		<i>Ratio after provision</i>
Return on equity	$\frac{1,670}{(4,954 + 5,656)/2} \times 100$	31.5%	$\frac{1,170}{(4,954 + 5,156)/2} + 100$	23.1%
Return on assets	$\frac{2,080}{(9,016 + 10,066)/2} \times 100$	21.8%	$\frac{1,580}{(9,016 + 9,566)/2} \times 100$	17.0%
Gearing	$\frac{4,410}{5,656} \times 100$	78.0%	$\frac{4,410}{5,156} \times 100$	85.5%
Operating profit margin	$\frac{2,080}{20,392} \times 100$	10.2%	$\frac{1,580}{20,392} \times 100$	7.7%
Earnings per share	$\frac{1,002}{6,000} \times 100$	16.7¢	$\frac{502}{6,000} \times 100$	8.3¢

- (b) Entities have moved towards meeting stakeholder demands for additional reporting, especially in respect of social and environmental issues. By producing such a report FW would indicate its willingness to respond to the pressure for a wider scope in reporting, and to be a good 'corporate citizen'. If we genuinely feel that there are corporate achievements in respect of social and environmental activity that are currently insufficiently publicised, a regular annual report on these aspects could be helpful and would perhaps enhance FW's reputation.

However, the publication of a social and environmental report is not a risk-free endeavour. If the report is too obviously a public relations document, it may arouse suspicion that we are indeed trying to 'deflect attention' from other matters.

The production of a high-quality report is not a trivial matter and it seems unlikely that it could be 'pulled together' very quickly. We are likely to incur substantial costs in producing a good report. Because there are no regulatory constraints on the content of such reports, businesses are able to be selective in their reporting (although it should be noted that the GRI does provide rigorous guidelines). However, having reported a piece of information on one occasion, we will set up an expectation that it will report a valid comparative in the future. This may be inconvenient where the indicator worsens.

Finally, the publication of a report may not produce the anticipated positive reputational effects. It may suffer in comparison with similar reports from our competitors.

- (c) The three principal sustainability dimensions are:
1. *Economic*: To include performance ratios related to the direct economic impacts of the entity on, for example, customers and suppliers.
 2. *Environmental*: To include performance ratios related to environmental impacts in such areas as biodiversity, emissions, effluents and waste.
 3. *Social*: To include performance ratios related to labour practices, human rights and product responsibility.



Solution 5

(a) Report

To: A

From: Reporting accountant

Date:

Re: The financial performance of Recycle (R)

The revenue of R has increased by 7.1% during the year, but over the same period its gross profit has fallen by 6.6%, from a gross profit ratio of 53.6% to one of 46.6%. During this period, operating expenses have increased by 33.3% and finance costs have doubled. These circumstances have had the effect of halving net profit before income tax, from a rate against sales of 28.5% to one of 13.3%. While income tax is lower, the effect of maintaining the dividend on reduced profits is to limit the retained profits available to finance investment. Dividend cover has fallen from 2.75 times to 1.25 times.

As profits have fallen there is evidence of expansion, as tangible non-current assets have increased by \$1,500 million [i.e., \$4,100 m – (\$3,800 m – \$1,200 m)], inventories by \$150 million and trade receivables by \$200 million. This investment has been financed by an increased overdraft of \$700 million, depreciation \$1,200 million, and retained profits \$50 million, less reduced credit for unpaid tax \$100 million. It is imprudent to finance non-current asset purchases from short-term overdraft finance.

There is clear evidence of poor management of working capital, which has deteriorated from a positive to a negative figure this year. The current ratio shows 0.91:1 for 20X7 as against 1.09:1 last year, and the quick ratio 0.62:1 this year against 0.77:1 last. This situation has been caused by the increase in the inventory-holding period (from 98 days to 114), and the receivables payment period (from 104 days to 122), largely financed by the increased overdraft. Creditors and the bank must be concerned by these items.

The gearing ratio shows little change at about 25%, but the debt:equity ratio has deteriorated from 0.72:1 to 0.92:1, and the interest cover is now only 3 times, against 9 times last year. This could presage difficulties in raising long-term funds to refinance loan payments in 20X9. Unless receivables can be collected faster and inventories controlled there may not be sufficient future cash flow to pay creditors, tax, dividends and the bank.

Signed: Reporting accountant

(b) The contribution made by published financial statements to satisfy the information needs of B, by addressing social and environmental matters, is disappointing. Such information contained in the corporate report is usually in the unaudited public relations section and not part of the financial statements.

GAAP offers little in the way of rules to ensure the disclosure of social or environmental information, other than figures for charitable donations and a crude analysis of the labour force, and details of the employment of disabled persons. It is very much left up to companies to decide what to disclose and how to disclose it. In the case of a material amount to clean up an environmental disaster, this would be noted as an exceptional item or as a provision for a future liability if a legal obligation existed.

Solution 6

As its name suggests, environmental reporting refers to the inclusion in the annual financial report of the actions of entities to maintain and enhance the environment. There are no detailed requirements for environmental reporting contained within international accounting standards. However, IAS 37 *Provisions, contingent liabilities and contingent assets* requires the reporting of certain environmental liabilities. Many jurisdictions are encouraging entities to provide environmental reports on a voluntary basis, and it is becoming increasingly common for listed entities to provide one. There appears to be a clear trend towards making such reports mandatory as the scope of stakeholder reporting widens. Reasons for the increasing incidence of environmental reports include:

- A greater acceptance that the financial report should contain information to appeal to a wide range of stakeholders, rather than merely to the arguably narrow interests of the equity investor group.
- An increasing perception that an annual report is a public relations document that needs to report the extent to which the entity is a good ‘corporate citizen’.

Solution 7

It is very unusual for a company to include its employees as assets in its statement of financial position. There are essentially two main reasons for this:

1. Assets are defined by the IASB in its *Framework for the Preparation and Presentation of Financial Statements* as ‘a resource controlled by the entity as a result of past transactions and events and from which future economic benefits are expected to flow to the entity’. It is questionable whether an employee could be regarded as satisfying this definition. It could be argued that, in practice, no contract of employment can *force* an individual to work so as to provide future benefits to the employer. Therefore, the essential features of the definition do not appear to be satisfied in this context.
2. Even if an employee can be regarded as an asset of an entity, that asset can only be recognised if it can be measured at a monetary amount with sufficient reliability. This means ascribing a cost or value to the employee. In most cases (although there are certain exceptions) no up-front payment is made in consideration of future services, so no valid cost exists. It would be theoretically possible to arrive at a value for an employee by capitalising the present value of future economic benefits but this exercise would be fraught with uncertainty. Even if such a value were to be computed, and the asset duly included on the statement of financial position, the question of period of write off would arise.

The exposure draft proposing changes to IAS 38 *Intangible Assets* considered, but rejected, the possibility of requiring recognition and measurement of the workforce and its related intellectual capital.

To summarise, the practical problems of accounting for human resources as assets probably outweigh the potential benefits.