Is more less?
Exploring a new world of corporate reporting

Part 4: Raising the game

Audit & Assurance

“The journey of a thousand miles begins with one step.”

Lao Tzu

A better measure of success

We live in an age in which we expect immediate access to information, goods, and services. We demand it in how we consume our news, buy an item, receive notification of a flight delay, or even order a coffee—"instant gratification" is the new standard.

Meanwhile, the frequency and nature of corporate reporting has not materially changed in decades. At the same time, the market's desire for more timely, relevant and indicative information about corporate performance has led to a proliferation of ad hoc measurements that fall outside the requirements of Generally Accepted Accounting Principles (GAAP). Regulators around the world are taking notice, sending strong messages to companies to provide more balanced disclosure against the comprehensively codified GAAP requirements. Certainly, non-GAAP disclosures create disparity in measurement since the key metrics vary from company to company and there are few, if any, codified standards to follow.

Throughout our series *Is more less?* we've heard from many stakeholders that the current reporting model, including the disclosures it prescribes, is not fit for purpose.

One of the reasons is that the preparers of public reports don't believe they can effectively tell the story of their business strictly within a GAAP framework. Another is that investors and analysts want information that better reveals current and future performance than what is prescribed by GAAP, and in reacting to the demand, companies create or use new metrics. Any such additional information is not prepared in accordance with codified standards and is usually not subject to external scrutiny, like existing GAAP requirements are. And yet this information may have the biggest impact on the market price, and often the brand and reputation, of the company.

Should the accounting profession care?

If investors care about this type of information, then the accounting profession—the guardians of the public trust—should as well. Ways in which the profession as a whole, both accountants and auditors, engage to provide value must be evaluated. The current corporate reporting model provides scrutiny and assurance on GAAP measures, yet fewer investors and other stakeholders are depending on those reports and measures as their key source of investment information.

Indeed, in *The End of Accounting* (Wiley, 2016), authors Baruch Lev and Feng Gu note that in the 1980s, stakeholders relied on financial reports as their primary source for 50 percent of information they needed to make their capital market decisions. Today, they rely on financial reports for less than nine percent of their decision-making input. What else do stakeholders use, and—crucially—how do we know if it's reliable?

Our series *Is more less?* set out to explore how to modernize corporate reporting. Created decades ago, in a time of much less regulation and fewer distribution channels, corporate reporting and reports now struggle to meet the needs of an increasingly fast-paced and complex global business environment. In *Raising the game*, we address the role of the auditing profession in providing assurance on information investors find valuable, not what tradition deems valuable, as well as how the audit profession can provide more value to clients and other stakeholders. We also look at what the accounting profession can do lead change in corporate reporting.

Reimagining corporate reporting

This statistic in *The End of Accounting* underscores our assertion that the corporate reporting model needs to be reimagined if it is to regain its usefulness to investors and stakeholders. It also points to a worrisome trend for the professionals who play a role in preparing these reports and in adding credibility to them. If Lev and Gu are correct and 91 percent of the information needs of stakeholders are met outside the financial statements—the only reports to which auditors add credibility—then what value do auditors currently bring to the capital markets? Does the auditing profession also need to be fundamentally transformed in order to retain its value and relevance?

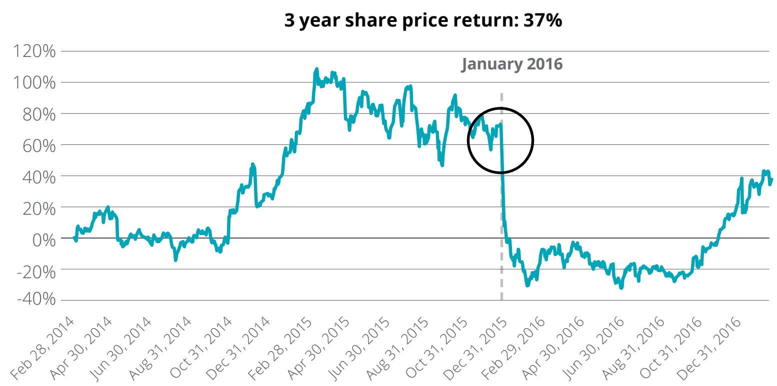
We believe it does. And as with any challenge, there is opportunity. We see this critical juncture as a ripe time to explore novel approaches and new ways of communicating crucial financial information to stakeholders. In essence, a time of change for corporate reporting is also a time for the auditing profession to raise its game to a whole new level.

System at a tipping point

We know stakeholders are focused on non-GAAP measures of performance because of their stock's behaviour in the market. Consider the following:

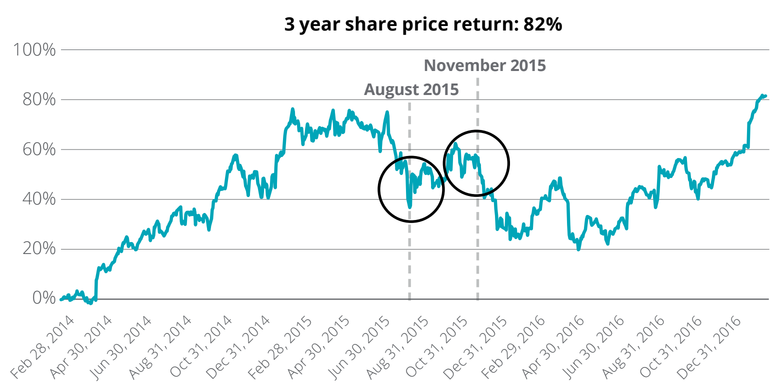
Chrysler Fiat

Automotive original equipment manufacturers (OEMs) release units of production sold on a monthly basis. In early January 2016, Chrysler Fiat announced there had been an error in its monthly reporting of units. The closing price of the stock dropped 4% from the prior day's trading price, and the next day the price fell another 3%.



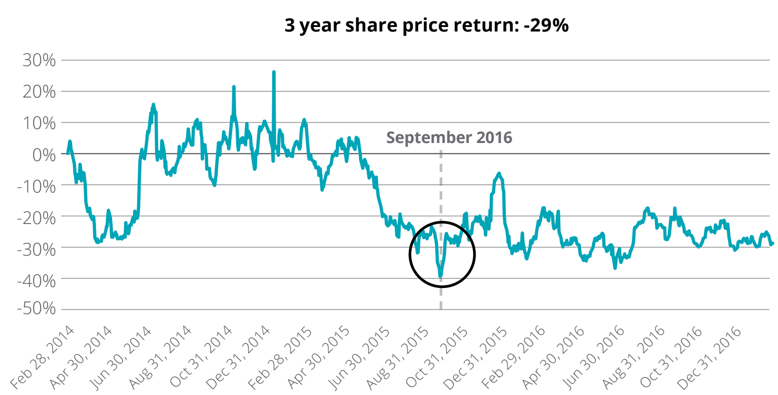
Apple

Apple is a company whose success is driven by innovation and product launches, and its position relative to competitors can lead to volatility. In August 2015, Apple announced a new product would be released the following month, and the price of its stock increased 5.6%. In November 2015, a report by an outside entity reported reduced component orders for Apple—and the stock priced fell 5.1%.



Blackberry

Blackberry's challenges in recent years haven't been made easier by the market's tendency to react quickly to rumours as well as announcements, which creates short-term volatility. In late September 2016, the Canadian tech firm announced it would cease production of smartphones to focus on software. This boosted the stock's closing price from the prior day's trading by 5%. The next day, the price fell 4%.



These market movements are based on real-time expectations of what the future will hold, in light of the most recent information available. These decisions are not rooted in historical, audited financial statements, but neither are they based on information that has been subject to external scrutiny and validation.

The profession needs to speak with one voice to effect change.

This is where opportunity lies for the auditing profession.

Seeking to expand and enhance the value auditors bring is an important and worthwhile step. Yet, to propel corporate reporting to the next level—to regain the interest of stakeholders—a strategic leap forward is required. For auditors, that means shifting the capital market's mindset. Recognizing the market now moves too fast to rely entirely on backward looking GAAP performance as an indicator of a company's future performance. Many have turned their attention to forward-looking value-creation metrics and other non-GAAP measures. Therefore, we need to consider the state of assurance on more relevant and longer-term measures. What can the accounting profession do to help develop new metrics that can be assured? What could companies be willing, or obliged, to do to follow guidance on these metrics?

However, some habits and behaviours may be hard to shake. Stakeholders must shed their preoccupation with companies reaching their short-term objectives, for example, to give organizations the breathing room to focus on the long term. That's where the greater rewards presumably lie: when investments made to create value, such as building a state-of-the-art facility or investing in the distribution network, begin to pay off.

Tomorrow's auditor: the agent of change

Creating fundamental change in corporate reporting requires the participation of all the players. One group in particular has a crucial role. Since regulation protects the investing public by ensuring capital market participants are held to a high set of standards, any meaningful change requires deep involvement from regulators as sponsors of change. Report preparers and auditors are not likely to make meaningful changes if the regulatory structure doesn't allow or support a new model.

While accountants and auditors should not overstep the natural boundaries of their professional standards, nor be expected to do so, undertaking an expanded role can be helpful to stakeholders. To be agents of change, accountants and auditors will have to:

- **Work more closely with preparers, industries, and regulators** to help identify critical value-driving indicators, define the criteria for measurement, standardize those measurements, and, finally, provide assurance on them
- **Work with organizations** on their control processes and procedures to help ensure the reliable production of information of most value to stakeholders, so that non-GAAP information shared with the investing public could have greater assurance
- **Partner with regulators to establish a framework** that will better meet the needs of twenty-first-century stakeholders and investors
- **Advocate for taking a long-term vision**, which would be reflected in a corporate reporting model that features more forward-looking measures, more frequent releases of key pieces of data, and less frequent comprehensive analysis and reporting

We see evidence of a growing interest in the benefits of such a "going long" strategy. Some of our own clients are starting to ask how they can take steps towards a longer-term vision, such as better defining value-creation measures and ultimately tying compensation to those measures.

One organization that has reimagined its corporate reporting is General Electric (GE), which in 2016 released its first integrated summary report to the market—one of the first of its kind. Jeffrey Immelt, chairman of the board and chief executive officer, wrote in his introduction that the report's intent was to "show investors GE through the lens of [its] management."

Using an integrated report summary to show GE through the lens of management to investors

"Public company reporting has become so complicated that what matters to investors can get lost. Our priority is to provide meaningful information that all investors can readily access. For investors to make investment and voting decisions, we don't believe that more information is necessarily better. Instead, we've challenged ourselves to provide better information. Over the past several years, we have already been enhancing our reporting in response to feedback from investors, and they have told us how much they like it. This year, we are taking it even further with our new Integrated Summary Report."

Jeffrey R. Immelt
Chairman of the Board &
Chief Executive Officer, GE
March 14, 2016

What needs to be done?

As we explored in previous parts of this series, useful change can occur even within the current corporate reporting structure. It takes only the commitment of an organization's leadership to create a culture of change, to exploit technology in a way that allows a better sharing of relevant information, and to have the patience and perseverance to hold a long-term view of success. Although some things like standard definitions could take broader collaboration, companies can clearly define, disclose and follow consistently.

The figure below sets out some examples, based on our entire *Is more less?* series, of rethinking, process, and assurance auditors can provide to create change.

	Rethinking	Process	Assurance
Short term	• Standardize definitions and measures within organizations • Enhance and modify existing reporting • Use plain language and advance use of technology in reporting	• Work with all stakeholders on reporting improvements, and improve ways to prioritize and describe risks • Identify information that is useful within an industry or sector	• Modify the audit report and reporting • Enhance use of analytics and control assessments • Provide some assurance to boards on value drivers (key performance indicators (KPIs))
Long term	• Develop new reporting framework • Demonstrate how to link purpose, vision, strategy, goals, performance, and management compensation	• Develop and define value-creation metrics (by industry) • Work with stakeholders to tailor the new framework • Organizations develop stringent processes for the timely release of reliable key metrics	• Revise assurance models for expanded disclosures related to key metrics and non-GAAP measures • Assure key information in a timely manner

Disruption: staying flexible is the new norm

Any new corporate reporting framework cannot be set in stone. It must be flexible and scalable to serve an era in which emerging trends and technologies can have deep and far-reaching repercussions for organizations. While deciding how to address such trends is firmly in the bailiwick of organizations, accountants and auditors would do well to also stay on top what's happening so they can better advise companies, as well as to determine if and how they themselves might need to respond.

Be a catalyst for change

Corporate reporting must change with the times; the alternative, as hinted at in *The End of Accounting*, is becoming a thing of the past. The best change, of course, is the one made by all stakeholders working together.

The good news is, we're already doing that. The ideas explored in our *Is more less?* series have not been ours alone. We've hosted panel discussions, held many one-on-one discussions, and otherwise invited the insight and ideas of directors and other capital markets participants from across Canada. We sincerely thank everyone for their participation to date.

We all know disruption is affecting nearly every business model and, by extension, profession. The rapid rate of change makes it difficult to be forward-thinking, yet those companies—and professions—that are not looking ahead and acting with courage, risk becoming obsolete. It's in everyone's best interest to diversify their capabilities and expand their horizons so they can create or enhance value for their customers and, by doing so, remain not only relevant but potentially become indispensable partners.

We hope the thinking published in this series acts as a catalyst for dialogue to ensure that necessary change happens. Setting the direction is a critical step but, of course, it's not the only one. We've got a good thing going—let's continue to work together to create a corporate reporting model that serves the business world far into the future, to make an impact that matters.

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