Communicating Value in the Twenty First Century

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1. Assigning value to a good or a service is not easy. The entire profession of cost accounting is devoted to the pursuit of this worthy objective. It is easy to realize how difficult it is to value a business enterprise when we look into it with a perspective that how technical it is to assign value to a single good or service.

Traditional Approach

2. Accounting has been in vogue since time immemorial. Early accounts served mainly to assist the memory of the businessperson and the audience for the accounts was the proprietor or record keeper alone. Since the history of accounting in other civilizations has not been documented so well, we shall confine ourselves here to Europe. By 15th Century, Italy had become a major center of international trade. Bigger ventures needed multiple investors. The investors wanted to know how well the enterprise in which they had invested had performed, say over a year. Simple recording of transactions, bought so many articles at given prices and sold so many of them at other prices did not make sense to investors. They needed a comprehensive view. In 1494, Luca Pacioli published a book named. *Summa de arithmetica, geometria, proportioni et proportionalità*. As will be evident from the name, it was a mathematics textbook. But it is famous and remembered for a 32 page Annex it had. The Annex described what is known as double entry accounting system. Pacioli is therefore rightly called the "father of accounting" because he was the first to publish a detailed description of the double-entry system, thus enabling others to study and use it. It helped to bring in the concepts that have resulted in today's balance sheet and profit and loss accounting without which we cannot think how the business world would even be contemplated, much less exist. The basic concept of double entry accounting has developed into several systems. One system with which we are most familiar is the traditional British system in which the rules of debit and credit are laid down for three laid down classes of accounts, viz. Personal Accounts in which receiver is debited and the giver is credited, Real Accounts where what comes in is debited and what goes out is credited and Nominal Accounts in which all expenses are debited and incomes are credited. These are finally arranged into balance sheet, being a stock position of the enterprise and profit and loss statement being the flow of it. Over a period of about three hundred years scores of important concepts were added to the accounting theory to ensure that the financial statements conveyed value of the enterprise in a better way, notably, Depreciation, Cost Accounting, Transfer pricing, Overhead allocation to each product, Cash/ Fund Flow Statements, Present Value - Discounted Cash Flow and Zero Based Budgeting. Spread of computers brought in Spread Sheets along with 'What if scenarios'.

Fair Value Accounting

3. Twentieth century, especially the second half saw development of the concept of fair value. It was felt that, traditional measures of value were particularly inappropriate for financial firms. International Accounting Standards – IAS 39 defined fair value as

> *Fair Value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction*"

This seemed to be a particularly smart and intelligent way to value assets and liabilities till we found that good old Swiss cheese had less holes in it than this. Using this you could declare profits even as market decided that you were a basket case.

Lessons learnt, IFRS 13 has made improvements over the definition. It goes as:

- *The price that would be received to sell an asset or paid to transfer a liability in an* ***orderly transaction*** *between* ***market participants*** *at the measurement date.*
- *Emphasizes that fair value is a market based measurement, not an entity specific. measurement.*
- *No distress sale.*

4. Debates about fair value accounting were shrill and acrimonious in the wake of the Global Financial Crisis. One could write a book about the debate but it will be sufficient here to recount some of the advantages and disadvantages. To be fair to fair value accounting, one has to admit that it provides

more accurate, timely and comparable information than that reported under existing alternative accounting approaches; is updated on a regular and ongoing basis; results in income figures which are of enhanced value – both in terms of stewardship and predictive value; helps bring accounting and risk management in alignment; and finally results in greater transparency.

5. The case against fair value cannot be dismissed lightly. It is accused to be unreliable as it may not be based on arm's-length transactions; developing reliable methods of measurement is a challenge; market inefficiencies, behavioral biases and investor irrationality may reduce its usefulness; distinction between fair value gains and losses occasioned by the activities of the management and those otherwise occasioned may be difficult; and there are difficulties in separation of windfall gains. The difficulties don't end here. The main accusation is that it introduces unnecessary volatility in the performance of financial firms that feeds on the overall volatility in a positive feedback loop. The reporting losses could be misleading if they are temporary and may reverse as markets return to normal. Communicating with stakeholders the effect of fair value accounting is challenging. Last but not the least it causes contagion.

Communicating Value Beyond Money

6. Among one of the blights of the twentieth century is the fact that all the public discourse started happening in financial terms. Money became, by consensus, the only measuring rod. We think that the only purpose for which an entity may prepare accounts is to convey to investors how much profit or loss it has made. There can be other reasons too. The Deeds of the Divine Augustus, a book about the a Roman Emperor dates back to 23 BC. The documentation in it is very detailed. It quantifies his public expenditure in several heads viz. distributions to the people, grants of land or money to army veterans, building of temples, religious offerings, and theatrical shows and gladiatorial games. One cannot imagine that the Emperor was creating records to satisfy 'The Comptroller and Accountant General of Rome". Obviously, the aim was not to account to anyone but to convey Emperor's munificence to populace and posterity. Accounting and Reporting have uses beyond the need to inform investors.

Sustainability Reporting

7. By the end of twentieth century, it had become clear to businesses that society expected from businesses a little more than simply earning money profits. Social and environmental concerns had become mainstream. It became accepted that markets rewarded those enterprises, which showed sensitivity towards environmental and social issues. Major companies started giving details about their work relating to these issues. In India too, the Ministry of Corporate Affairs issued National Voluntary Guidelines (NVG) in 2009 and later revised them in 2011. These were applicable to all companies irrespective of size, sector or location. Nine principles were laid down and all principles are equally important and indivisible and are to be adopted comprehensively. Reporting framework made on Apply or Explain basis. It might be a little boring but it is worthwhile to reproduce the principles laid down in the NVG.

1. *Businesses should conduct and govern themselves with Ethics, Transparency and Accountability.*
2. *Businesses should provide goods and services that are safe and contribute to sustainability throughout their life cycle.*
3. *Businesses should promote the wellbeing of all employees.*
4. *Businesses should respect the interests of, and be responsive towards all stakeholders, especially those who are disadvantaged,vulnerable and marginalised.*
5. *Businesses should respect and promote human rights.*
6. *Business should respect, protect, and make efforts to restore the environment.*
7. *Businesses should support inclusive growth and equitable development.*
8. *Businesses, when engaged in influencing public and regulatory policy, should do so in a responsible manner.*
9. *Businesses should engage with and provide value to their customers and consumers in a responsible manner.*

8. Businesses have an incentive in actually complying and showcasing how compliant they are. There are certain inherent advantages in following these principles while others accrue from improved perceptions about the company. They may have cost savings and improvement in productivity through reduced cost of ambiguity and reduced litigation, and access to new customers. The firm may have revenue growth as it might attract newer customers and reach out to new markets. It might have better access to capital as it will be more attractive to investors and banks. A highly compliant firm will be attractive to financial markets as it will have better risk management. There might be no threat to its license to operate as it is positively seen by the community, NGOs, local government, and regulators. It may improve its human capital as it will attract and retain better trained and consciencious employees. Its brand value and reputation will soar as it will be positively seen by customers, regulators, and media.

9. SEBI in 2012, mandated NVG for top 100 listed companies. Since there were many companies that were already submitting Sustainability Reports to International Agencies, it was decided not to require separate reports but only to map their existing reports to the NVG format. SEBI, however has gone a step further and made reporting more specific. It has also asked companies to name top 3 products where design has incorporated ESG concerns, reduction in use of resources, local procurement etc. This a step in the right direction.

Integrated Reporting

10. Having gone over the history of communicating value over last few centuries , it is time to try to have a peep into future. It will be important to debate how corporations in the twenty first century will like to communicate with their stakeholders. Integrated Reporting (IR) is One such model promoted by International Integrated Reporting Council (IIRC). IIRC is a global coalition of , regulators, investors, companies, standard setter, accounting professionals and NGOs. More than 1000 companies including some Indian companies are already reporting in the IR format.

11. The objective of IR is to capture creation of value over time. The main premise of IR is that financial capital is not the only capital that is used by the companies. Reporting is one sided and incomplete if it is confined to recounting how equity and debt provided as financial capital are utilized by the company. When the investors invest in the capital of a company, it is expected that the management will run the company in such a way that the invested capital will be enhanced and will also yield dividends. Regeneration of and accretion to capital is the hallmark of a successful business. A business uses many capitals other than financial capital. For example, a company uses buildings and plants in carrying out it's activities. A company that takes good care of its buildings and plants and keeps on adding to their value and functionality will be more successful in the long run than one which does not take care. The neglect or the abuse might not immediately reflect in their financial statements. Bankers know this fact instinctively. That is why they always make it a point to visit the plants of a company before taking a final decision to lend. They know that financial statements are not enough. This kind of capital is called Manufactured Capital (MC) in the IR parlance. The Manufactured Capital might belong to the company or it might belong to society. For example, roads and ports are the publicly owned Manufactured Capital. A company may enhance the MC during a year or it might destroy it. A mining company might think that it is being smart in overloading its trucks and showing a little better financial profit. Yet in the long run it will be damaging the roads it uses and the costs will escalate exponentially in future. It must be now obvious why Manufactured Capital should be accounted for.

12. Most of the companies now do account for their Intellectual Capital in the sense of patents. There is a little more to intellectual capital than simply patents. It is the sum total of processes and procedures that are embedded into the business model of a company that marks an outstanding company from its mediocre counterparts. Even this type of intellectual capital is to be recognized and attempts made that it is enhanced over a period of time rather than letting it deteriorate. Closely linked to it is Human Capital. There was a time in the beginning of Industrial Revolution when financial capital was most important for a company because other factors of production viz. land and labour were considered as a commodity. Labour was surplus and was unskilled. One pair of hands was as good as another. If on labourer fell sick or died, another quickly replaced him. Learning at the job took a couple of hours at the most. It is the other way round these days. It is the finance that has become a commodity. You can get it from anywhere in the world at the click of a mouse. At the very worst, you might have to pay a few basis points more. On the other hand, it is often impossible to fully replace a creative and knowledgeable employee. Companies like Google are entirely dependent on the skill and creativity of their employees. Human capital, therefore, needs to be recognized and accounted for.

13. No company can exist in a vacuum. It is a part of the society and uses inputs put in by the society. For example, a software company does employ engineers trained by the local engineering colleges. If it neglects to help these colleges to upgrade themselves, it will lose out on the quality of future recruits. On a broader scale, a company can operate only till such time as the society gives it the license to operate. The day, the company loses that goodwill, its days are numbered. Therefore, it is necessary to also account for Social and Relationships, like we do for other types of capital.

14. Last, but absolutely not the least, is the natural capital that a company uses. Every business uses air and water though it might not always be obvious. It is not only the power plants that use enormous quantities of water. Integrated chip manufacturing involves unbelievably large quantities of water. There was a time it was considered kosher to abuse the environment thinking that only the future generations will pay for it. It is no longer true. The environmental balance has reached such a delicate stage that the environmental debts are to be paid here and now.

15. IIRC has provided a very detailed reporting framework for Integrated Reporting (IR). The most important element of IR is its strategic focus and future orientation. It requires the companies to tell about opportunities, risks and dependencies flowing from market position and business model. It requires them to tell about availability, quality and affordability of various capitals. The companies are warned to avoid boilerplate disclosure because unlike usual reporting, here we are reporting an uncertain future and not a definite past.

16. The information in the IR framework entails both quantitative and qualitative aspects. It is, therefore, so vast that without a focus on connectivity of information IR will become a jumble of unconneced facts. IIRC encourages the companies to tell the comprehensive value creation story with reference to external environment, governance, opportunities and risks, strategy and resource allocation, business model and performance, and future outlook. The idea is to tell how a user can understand the future of the company. The most important element of connectivity is how each kind of information connects to financial information.

Conclusion

17. The reason why I have described the IR framework in such great detail is not to advocate or suggest mandating it. Looking at the history of communicating value, it is obvious that over the last few centuries, attempts have been made to capture more and more aspects of business so that markets are able to perform their resource allocation function efficiently. In absence of a reliable measuring system, mis-allocations drive the economy to near catastrophic situations such as the recent Global Financial Crisis. There is a strong need to be aware how important it is that accounting should incorporate all the societal concerns. The entire society is to be now involved in this debate. To sum up, accounting has become too important to be left to accountants alone.