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CORPORATE PERFORMANCE REPORTING: RELEVANCE LOST, RELEVANCE REGAINED?[1]

Increasingly, an organization's success is a function of its ability to effectively manage non-financial assets and intangible value creating activities. This paper examines the calls for and preliminary experimentation with non-financial performance measures aimed at restoring relevance to the corporate reporting process.

Wanted: New Performance Measures

Recently, there have been calls for the development of new metrics to assist in evaluating economic performance. Both the American Institute of Certified Public Accountants (AICPA) (Financial Accounting Standards 1999) and the Canadian Institute of Chartered Accountants (CICA) have called for the development of new non-financial measures and broader financial performance measures that are needed to track organizational performance in the new economy. Corporate governance guidelines require that Canadian boards of directors ensure that strategic planning processes are in place (Waterhouse and Svendsen 1998) and firms need to know the levels of resources to devote to value-creating activities. Conventional accounting systems cannot be expected to provide the information needed to effectively assess such initiatives in the knowledge-based and service sectors. Steven Wallman, former commissioner of the U.S. Securities and Exchange Commission maintains that "assets like customer satisfaction and employee loyalty are increasingly viewed as drivers of wealth production and earnings. If measured reliably, they can provide critically important information to the financial markets" (Baltes 1997 7).

The CICA is engaged in researching new methods and reporting frameworks which should enable CAs to report to senior management, boards of directors and eventually the shareholders on this broader basis (Chartered Accountants of Canada 1996). The trade ministry in Denmark currently has 20 companies engaged in a three-year project to produce intellectual capital reports as part of developing guidelines on supplemental performance reporting (Measuring intangible assets 1999). In June, 1999 the government of the Netherlands, together with the Organisation for Economic Co-operation and Development (OECD), sponsored an international symposium *Measuring and Reporting Intellectual Capital: Experience, Issues, and Prospects*. At this forum, "researchers and company representatives reviewed results of recent

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surveys of 1800 companies, and case studies and experimentation in 125 companies in OECD member countries" (Symposium on Measuring 1999). Forum chairman, Stuart Hornery, concluded:

> "International organisations, governments, standard setters and other stake holders should encourage experimentation that would lead to general principles or guidelines for reporting key intellectual capital and information on value creation. They should systematically monitor and evaluate the results of such experimentation.

At the Amsterdam symposium, the Chair of the CICA, Beverley Brennan, echoed the call for experimentation in performance reporting, but at a more cautious level of internal reporting to the Board of Directors and senior management. It is the CICA's position that there should be a moratorium on related standard-setting for at least three years so as not to discourage experimentation with intellectual capital and other value-creating metrics (Brennan 1999). In the United States, the Financial Accounting Standards Board is currently developing recommendations for the voluntary and broad disclosure of certain types of business information for all or for selected industries that users of business reporting find helpful in making investment decisions. Alternatives are also being sought for ways to coordinate generally accepted accounting principles and Securities and Exchange Commission disclosure requirements and to reduce redundancies (Financial Accounting Standards 1999).

The calls for new performance measures to supplement traditional financial accounting are driven by an economy in which the real drivers of value lie more in intangible rather than tangible assets. The fact that intangibles such as customer loyalty, employee satisfaction and intellectual capital are often developed internally, as opposed to being acquired through a third-party transaction, means that the estimation of their future benefits is, at best, subjective. Reliable external financial reporting typically dictates that costs associated with such "soft" assets be expensed as incurred, thereby leaving balance sheets void of some of a company's most valuable assets. The penalty in earnings from expensing such investments is reflected in relatively high price-earnings multiples in the technology sector (Condon 1999). The absence of the Coca-Cola brand name and distribution system from its balance sheet contributes to a market capitalization of nine times book value (Ibid.). It is recognized that it is not the purpose of financial statements to put a value on a business and that a debate on the efficiencies of capital markets is beyond the scope of this current paper. Nevertheless, such statistics highlight the need for investors and creditors to turn to alternate sources of information in order to predict "…the ability of the entity to earn income and generate cash flows in the future to meet its obligations and to generate a return on investment" (Canadian Institute 1000.12 1999).

Economic Value Added

Over the past number of years, many companies have been turning to consultants to move beyond traditional financial reporting and measure how much value is being created or destroyed. Stern Stewart's Economic Value Added (EVA) model is embraced by a number of large companies seeking to manage long-term economic value rather than earnings per share. The concept is grounded in the notion that companies should not look at reported earnings, which are subject to accounting distortions, but at how returns exceed cost of capital. A company creates value only if the return on its capital is greater than the opportunity cost of it, or the rate that investors could earn by investing in other securities with the same risk. After calculating a company's true cost of capital for equity and debt, the combined number is subtracted from operating profits. What is left over is the economic value added, the reward stockholders get for investing with this company rather than elsewhere. If it is a positive number, the company is headed in the right direction. If not, the company has failed an all-important wealth-builder test and the stock price could decline (Barfield 1997; Stalk 1998).

EVA is constrained by the limitations of generally accepted accounting principles. The fact that up to 164 adjustments must be made to the accounting numbers for things such as capitalization and amortisation of intangibles, makes the process somewhat tenuous and costly. Critics argue that EVA is a backward-looking measure that is biased against new assets whose book values remain high. Consequently, managers may be discouraged from investing in a business if EVA will drop (Barfield 1998). EVA is particularly difficult to estimate for financial institutions which must set aside capital for regulatory reasons; high growth or young companies where most of the revenue calculations have to be guesswork; and industries where many of the assets are intangible (Valuing Companies 1997). Although a number of large companies swear by EVA, it clearly is not a panacea for all attempts to determine how current strategies are likely to affect future values.

The Balanced Scorecard

The balanced scorecard was introduced in 1992 as a means to assist in managing through the use of both financial and non-financial indicators. Results of a year-long research project with 12 companies led Robert Kaplan and David Norton to conclude that no single measure can provide a clear performance target or focus attention on the critical areas of the business; rather, what is needed is a set of measures that provide a comprehensive view of the business (Kaplan and Norton 1992 71). The balanced scorecard complements historical financial results with operational measures of future financial performance: customer satisfaction, internal processes, and the organization's innovation and improvement activities. It brings together in a single management report, the many diverse elements of a company's competitive agenda: becoming customer oriented, shortening response time, improving quality, emphasizing teamwork, reducing new product launch times, and managing for the long term. This approach allows managers to see whether improvements in one area of business are achieved at the expense of another.

Despite the simplicity of the basic idea and the increasing number of organizations which are using or implementing scorecards, there are claims that 70% of scorecard implementations fail (McCunn 1998 34). Accordingly, KPMG cautions its clients to not start implementing the balanced scorecard unless they are clear what the processes should achieve. Implementation is time-consuming as the scorecard must be tailored to each organization's operations. The incremental costs of training, administration and periodic scorecard reporting should be borne out by beneficial changes in the way that business is run. Despite the academic respectability of the model, questions remain concerning the extent to which the balanced scorecard or other non-financial performance measurement systems are providing meaningful and actionable information.

How Non-financial Performance Measures Are Used

CUSTOMER LOYALTY

To improve upon the knowledge concerning new non-financial performance measures, the CICA funded a survey of top executives in U.S. Fortune 500 and Canadian Financial Post 300 companies (Stivers et. al. 1998). Of the 253 responding firms, 92.9% rated customer service factors as highly important (Ibid. 47). Although two components of customer service, "customer satisfaction" and "delivery performance/customer satisfaction", are measured by about 80% of respondents, some 25% of these companies do not use the results in their planning process. The obvious question is why would companies allocate resources for collecting data that will not be used. Are there problems with the design of the research instrument, the frequency of data collection, the reliability of results, or the establishment of links between customer service factors

and financial results? Are databases crowded with numbers that are not being effectively analyzed? Is customer satisfaction viewed as a "motherhood" quality that should be delivered indiscriminately? To what extent is a company able to estimate whether its service initiatives will promote loyalty and an increase in economic returns?

The value associated with loyal customers has become a key strategic concept in the area of relationship marketing, which, by definition, requires a forward-looking approach to the value of a customer relationship (Reichheld 1996). Given that the return from such marketing efforts is not immediate or measurable through traditional systems, it has been proposed that indices be developed to identify those customers with whom management wishes to do business (Cumby and Barnes 1996). These relationship indices could serve as a first level cut-off to identify those customers that management wishes to learn more about. In this way, resources would not be wasted on futile data collection and mining. This method is best suited for those industries where detailed customer databases are an integral part of daily operations: financial institutions, insurance agencies, airline and travel agencies.

However, even those companies that typically deal with anonymous customers, can develop innovative measurement techniques which enable managers to tailor their services so as to enhance profitability. The service profit chain, developed by faculty from the Harvard Business School, posits that the provision of high-quality employee support services leads to satisfied employees who are able to deliver better results to customers. Customers who are satisfied with the value of the services that they receive should be more loyal, and contribute to a growth in corporate profits (Heskett et. al. 1994). This is illustrated with several examples including Taco Bell's system of using the results of employee surveys to provide an environment in which employees are encouraged to contribute to customer satisfaction. Taco Bell "discovered that the 20% of the stores with the lowest [employee] turnover rates enjoyed double the sales and 55% higher profits than the 20% of stores with the highest employee turnover rates" (Ibid. 169). Given the positive impact on profitability from a satisfied customer base, the company links customer satisfaction ratings to managers' financial compensation.

The CICA recently sponsored a survey to determine the extent to which financial and non-financial performance measures that are reported to the board of directors fit with corporate strategic priorities. The survey also examined the extent to which performance measures improve with good governance (Waterhouse and Svendsen 1998). CEOs and board members agreed on the importance of strategic priorities, with two exceptions: CEOs rated customer relations higher than did board members, and board members rated environmental, health and safety concerns higher than did CEOs (Ibid. 14). It is not evident whether this interest in customer satisfaction by CEOs is motivated by executive compensation schemes linked to such measures. Likewise, legislation making board members personally liable for compliance with environmental, health and safety regulations (McLean 1999a) would promote interest in such issues. Waterhouse and Svendsen (1998) call for well-designed performance measurement systems that can establish a chain from some aspect of employee behaviour to customer satisfaction, customer retention and customer profitability.

EMPLOYEE SATISFACTION

Sears, Roebuck and Company has implemented such a system, drawing on data from thousands of customer and employee satisfaction surveys as part of a three-year rebuilding of the company around its customers (Rucci et. al. 1998). Sears is pleased with the ability of its *employee-customer-profit model* to predict changes in key financial indices based on changes in employee attitudes. The cause-effect relationship of employees-customers-profits makes sense in a retail business. Particularly encouraging is the fact that Sears has been able to develop its Total Performance Indicators (TPI) model based on non-financial performance measures and that the numbers are reliable enough to be audited every year by the company's accounting firm. Sears

has instituted a long-term executive incentive plan based one third on employee measures, one third on customer measures and one third on traditional investor measures. Nearly every manager has some compensation at risk on the basis of non-financial measures, a policy that will surely encourage buy-in to the model.

The key question emanating from the Sears story is whether other organizations can use this approach to link employee attitudes to financial performance. How has Sears has been able to quantify the relationship so as to estimate a 0.5% improvement in their revenue growth triggered by a 5-point improvement in the attitudes of Sears' employees? For the model to be truly useful, each of its components must be measurable. "Most companies do not have a well-established employee survey program, as does Sears. Additionally, collecting employee opinion data as frequently as is necessary to make full use of the model may be administratively onerous and impractical" (Summers 1998). Even if an organization is able to establish pertinent measures for each of the components in the model, its predictive ability for enterprises in other industries may be diminished if the linkages between the various stages of the model are less subtle or the lag effects more dramatic.

There are difficulties with establishing credible measures of more nebulous value drivers. In the aforementioned study of the attitudes of Fortune 500 and Financial Post 300 executives, there was a perception that innovation and employee involvement are less important than other non-financial measures (Stivers et. al. 1998). These attitudes may reflect a skepticism towards soft measures in general or a more pragmatic view that the cost of capturing reliable, meaningful data may not be absorbed by operational improvements. However, a study by Ernst & Young's Centre for Business Innovation found that major investors' decisions are significantly influenced by non-financial performance information (Low and Siesfield 1998). Sell-side research "analysts showed the greatest interest in customer and product-related factors – things like market share, customer retention, and marketing – with only slightly less interest in internal and employee-related factors and innovation-related factors. Moreover, the importance attached to non-financial information by analysts – and the types relied on most heavily – varied from industry to industry. In evaluating high-tech and service growth companies, for example, analysts tended to attach greater importance to non-financial data in their forecasts and recommendations" (Ibid.). Such findings support the calls for companies to experiment with the reporting of such measures internally and/or externally.

Intellectual Capital

Skandia Assurance and Financial Services of Sweden is generally recognized as a pioneer in externally reporting supplementary indicators of the company's value-creating processes. Since 1994, Skandia has been publishing a supplement to its annual report, which provides qualitative descriptions and quantitative indices of the company's intellectual capital as identified by the Skandia Navigator. This model parallels the balanced scorecard with its financial, customer, renewal and development, process and human focuses. The company's supplementary reporting is still in an evolutionary stage as efforts are made to accentuate its best competencies and to educate stakeholders as to the significance of the various components of intellectual capital. Although consensus has not been reached on an exact definition of intellectual capital, it is generally agreed that intellectual capital is a component of the multiple between a company's market value and its book value (Edvinsson and Malone 1997). However, it is not enough to establish metrics for intellectual capital. Stakeholders are interested in the extent to which you can leverage these competencies in the marketplace. Intellectual capital accounting must incorporate the fact that what might be a key indicator for one company could be trivial for another, depending on the industry it is in and the strategy that it has chosen to follow (Stewart 1997).

A variety of organizations have institutionalized intellectual capital management (ICM) into their on-going operations through the creation of executive positions, the offering of leadership development programs and seminars, and the development of knowledge assessment tools (Harvey and Lusch 1999). Since 1993, a group of approximately 30 international companies, known as the ICM Gathering, has met periodically to compare ideas and approaches for managing intellectual capital (McLean 1999b). ICM Gatherings include representatives from a variety of organizations including the CICA, Skandia, Dow Chemical, Coca-Cola, Dupont, Monsanto. A number of these have significant amounts of intellectual assets from which they wish to extract the maximum value, a task that is somewhat formidable given that traditional accounting systems are not designed to capture pertinent measures.

The challenge lies in making the link between intellectual capital or other value-creating intangibles and financial performance. Without such a connection, this entire exercise will be dismissed as being purely academic, with little relevance to the real world (somewhat reminiscent of the accounting profession's experience with current value accounting). It will require a big leap before organizations are in a position to be able to reliably link customer loyalty back to how satisfied employees are, and to link customer satisfaction forward to reliable estimates of economic returns. Are users even looking for assurance-level reporting on such measures? Is this a lofty and unrealistic proposition fuelled by an illusion of business development opportunities for professional accountants? Will stakeholders be satisfied with a mixture of qualitative and quantitative reporting of such measures through alternate means such as electronic press releases, appended by disclaimers as to the uncertainties and risks associated with any forward-looking information contained within?

Views from Atlantic Canada

In an effort to glean information on receptiveness to measuring and reporting non-financial performance measures, qualitative research is on-going with a selection of Atlantic Canadian companies that are traded on the Toronto Stock Exchange. Drawing on the Skandia experience of publishing supplements to its annual reports, research focused on attitudes towards reporting measures of intellectual capital to shareholders. Preliminary results indicate a need to refine future investigations to address two issues; of primary interest will be the merits associated with gathering and analyzing data on non-financial performance metrics. The secondary issue will involve a discussion of the means by which this information should be communicated.

An analysis of the annual reports of the publicly traded companies brought to light some common themes with respect to non-financial performance measures. There are frequent discussions of the importance of employee knowledge and capabilities, improvement of internal processes and cost reductions, the development of strategic partnerships with important stakeholders and the development of internal processes and cost-cutting measures. Organizations are realizing the benefits of becoming leaner and forming strategic partnerships with suppliers, key industry leaders, customers and the community in general. The presentation of such results to external stakeholders is not necessarily reflective of the attitudes of those responsible for finance and accounting functions within the organization. As might be expected, traditional thinking still surrounds the reporting of "soft" measures that may be quite relevant to users, but be lacking in reliability and/or predictability. If third-party assurance cannot be attached to non-financial measures, does a company run the risk of misleading users and leaving itself open to lawsuits? Accountants within these Atlantic Canadian companies were questioned as to whether they thought international standards should be set for the measurement of intellectual capital. One pointed observation was that it is hard enough to standardize generally accepted accounting principles with respect to the rest of the world, let alone measures that don't even exist! This line

of thinking supports the CICA's call for a moratorium on standard-setting while experimentation with internal reporting and measurement continues.

While respondents can quite easily identify various sources of intellectual capital within their organizations, they do not always have systems in place to capture or protect such sources of value creation. In service and knowledge-based industries, some of the most valuable assets are also the most transient: employees and customers. Some companies are particularly vulnerable when employees leave as they take with them valuable knowledge and/or clients. The literature on intellectual capital stresses the need to turn tacit knowledge into codified knowledge so as to enhance organizational learning and insure against the negative effects of employee turnover (McLean 1999b). It has been argued that an organization's vulnerability to employee turnover leaves it open to the complement of intellectual capital: a potential "intangible liability", something about which senior management and the board of directors must be cognizant (Harvey and Lusch 1999). Experimentation with employee satisfaction and loyalty measures for internal reporting purposes may lead to a better understanding about the foundation for value creation for many organizations.

Despite the presentation of various sources of intellectual capital to stakeholders in the Management Discussion and Analysis of annual reports, interviewees are generally reluctant to report quantitatively on non-financial performance measures. Concerns about disclosure of such information to outsiders include cautions about the reliability of non-traditional metrics. As well, there are echoes of the reservations expressed upon issuance of new accounting standards for segment information: a diminishing of the entity's competitive position, and the lack of comparability between enterprises, particularly because of the differences in the bases on which management information is measured and aggregated (Martin 1997). FASB and the CICA argue that knowledge of the basis on which management has chosen to structure and operate an enterprise is itself valuable because it highlights the risks and opportunities management believes to be important. Although segment information may not be comparable over time within a single enterprise or comparable between enterprises, such management information is likely to be relevant to investors and creditors as well as reliable for their purposes (Ibid.). Variation in intellectual capital frameworks is necessitated by strategic and operational differences and a direct comparison between companies will be possible only to the extent that companies have similar strategies, products and markets (Booth 1998). Debate on these points will be accentuated by those users who do not have the power or influence to talk to management, yet are seeking an informational advantage.

Future Research Implications

To say that education of both users and preparers of non-financial performance measures will be challenging is quite an understatement. Some will insist on providing a causal link between all reported measures and future profitability. However, the establishment of such a link is not now, nor likely ever to be possible for things such as a company's community involvement or patronage of the arts. Yet, many companies are not willing to risk the loss of business by *not* being involved in such activities. Therefore, the reporting of such ventures is probably best left at the qualitative level. However, there are many benefits to raising the awareness level of the importance of things such as customer loyalty and employee retention. Those advocating experimentation with the reporting of non-financial performance measures may be assuming that companies are currently talking to employees and customers on a frequent basis. Such is not necessarily the case, even for those organizations with affinity cards and customer loyalty programs. In the process of trying to expand their knowledge of some soft assets, companies may identify potential liabilities and put systems in place to counter things such as the potential loss from dissatisfied employees who are responsible for client relationships.

The identification, measurement and analysis of non-financial metrics associated with a firm's value-creating activities appears to be more than a passing fad in an era of management buzzwords and techniques. The quest for relevant predictors of stakeholder wealth and the establishment of causal links between an entity's various value-creating activities have resulted in significant investment of resources. Advances being made by individual professional services firms such as Arthur Anderson, KPMG, and Ernst & Young, and the leadership being provided by the professional accounting bodies are critical. However, professional accountants need to appreciate that we do not hold a monopoly on the provision of information essential for the efficient management of those organizations whose success is dependent on non-traditional or non-capitalized assets. Expertise in this area is also being provided by corporate strategy firms such as Bain and Company and Mercer Management (Reichheld 1996; Slywotzky 1999). Accountants must decide if they wish to be part of the quest for relevant and reliable non-financial performance measures or if they would prefer to try to play catch-up if and when firms decide to report such metrics to external stakeholders, possibly with some sort of assurance attached.

In order for companies to respond to the CICA's call for experimentation with new metrics, they will have to be sold on the benefits of what will undoubtedly involve a significant commitment of resources. To what extent will benchmarking of such data be possible? At the very least, such benchmarks would need to account for differences among cultures, industries, and stage of product life cycle or development. It is readily acknowledged that what is acceptable in terms of customer service levels in North America is higher than in, say, some European countries. The key success factors for a company engaged in the provision of high-tech solutions may rest primarily in the area of employee retention, whereas a pharmaceutical or biotech firm may be keenly appreciative of renewal and development processes. Those organizations with operations in different geographic locations and at various stages of growth will have varying areas of concentration. The interest in mature operations may be related to profit and customer satisfaction gauges, whereas the critical areas for new ventures may be the development of distribution networks and supplier relationships. Contextual factors add to relevancy; an Aliant or Keltic Technologies computer consultant has minimal value to the business acquisitions unit of Vector Aerospace and vice versa. As such, what is relevant to users will change according to circumstances and over time. The establishment of benchmarks for all measures may not be realistic. However, there *is* a need for more relevant information concerning an organization's many sources of value creation. Experimentation with new metrics is a logical first step towards determining the role that accountants should play in helping to improve corporate reporting.

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