INTEGRATING THE BUSINESS REPORTING SUPPLY CHAIN

A Summary of Key Recommendations

Governance • Financial Reporting • Financial Auditing • Integrated Business Reporting

In times of crisis, the basic elements of managing a company, such as governance, accounting, and auditing, should stand like a rock in the storm.

– Joe Kaeser, CFO, Siemens AG

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HIGH-QUALITY BUSINESS REPORTING

High-quality business reporting lies at the heart of strong capital markets and sustainable economic growth. All those involved in the business reporting supply chain play a critical role in making business reports more relevant, understandable, and reliable for the various stakeholders who use those reports to make informed decisions with respect to an organization's economic, as well as its social and environmental, performance.

The IFAC Business Reporting Project Group interviewed 25 key leaders (see back), representing all the links in the business reporting supply chain, to obtain their views on what preparers, management and directors, auditors, regulators, investors, and others should do to effectively improve governance, the financial reporting process, the audit of financial reports, and the usefulness of business reports in the aftermath of the financial crisis. The key recommendations from these interviews are featured in a full-length report and summarized here. To learn more about the project group and its previous work, and to access the full report and interview transcripts, visit the IFAC website at www.ifac.org/frsc.

You all have heard of 'the tone at the top.' I talk about 'the tone at the top, the tune in the middle, and the beat of the feet at the bottom.'
– Mervyn King, Chair, King Committee on Corporate Governance

Business reporting is not a compliance exercise, but a communications exercise with your stakeholders.
– Jane Diplock, Chair, Securities Commission of New Zealand

IMPROVING GOVERNANCE IN ORGANIZATIONS

- **Good governance starts with tone at the top.** Boards should formulate the values to which they will adhere in a code of conduct and instill those values throughout the organization.
- **Principles-based, stakeholder-driven governance codes offer a stronger chance of success than a legislative approach.** The "apply or explain" principle provides boards with the freedom to apply principles appropriately within the context of the situation and in the best interest of the organization.
- **Further international convergence is desirable.** To reduce the complexity and costs associated with compliance, governance, risk management, and internal control requirements across jurisdictions should be further converged and standardized.
- **More independence should be required of boards of directors** by, for example, requiring over half of a board's members to be independent non-executive directors and separating the positions of CEO and chairman.
- **Directors should competently fulfill their duties.** To this end, organizations should ensure that their directors have the capacity to approve the organization's strategy, including risk management, and to evaluate the way strategy is executed and reported upon.
- **Risk and liability for directors should be addressed.** If directors perform their duties diligently, they should be given a degree of liability protection. In addition, governments should legislate for the apportionment of blame and damages for a corporate failure to make clear that all stakeholders have to assume a degree of responsibility to prevent corporate failure.
- **The primary responsibility of directors is performance—not compliance.** Organizations should make good governance part of their mindset, focusing on long-term, sustainable value creation for all stakeholders, rather than short-term compliance with governance regulations.
- **Expand from a shareholder to a wider stakeholder perspective.** Organizations have an ever-growing environmental, social, and economic impact on societies and should, therefore, take into account not only the interests of their investors, but also those of their clients, employees, suppliers, neighbors, governments, regulators, financial markets, and societies as a whole.
- **Organizations should take social and environmental, as well as economic, performance into account.** Sustainable performance is the combination of these three factors, which should be aligned with an organization's strategies, operations, and stakeholder communications. Successful organizations demonstrate that sustainability is also good business.
- **Executive remuneration should be aligned with the organization's sustainable performance relative to its competitors.** To ensure that executives are remunerated fairly and responsibly, boards should develop a remuneration policy for their senior executives and put it to a non-binding vote to shareholders.
- **Ongoing risk management and control should be a key part of board oversight.** Organizations exist as part of an open system of dynamic social, environmental, and economic risk variables. Therefore, risk management and control systems should become a key part of integrated management at every level of an organization and across all operations.
- **Collaborative effort is required to address systemic risk.** Securities regulators, central banks, and other financial regulators across the globe should collaborate to form an empowered, supra-national oversight body to identify systemic risks in the markets and ensure a solid international financial infrastructure.

- **A globally coordinated system of governance, regulation, and oversight is needed to prevent future crises, but with care not to deter innovation.** Moving to global regulation and oversight of financial reporting and auditing is part of this new financial infrastructure.
- **Investors and other stakeholders should more actively pursue their responsibilities.** Investors in particular should be more assertive in the way they challenge boards regarding their decisions and application of governance principles. Responsible investor codes of conduct could lead to much-improved monitoring of governance and sustainable performance.

IMPROVING FINANCIAL REPORTING

- **It is critical that financial reporting becomes more relevant and understandable to the various users.** Organizations should provide simple building blocks of business information, grouped around topics of value to stakeholders. Consideration should also be given to the education of retail investors.
- **The use of a direct cash flow statement should be encouraged** to allow the investor community to more clearly see the operating performance of the business and the investment decisions being made, as well as how the business is being financed.
- **Financial reporting standard setters should simplify their standards** so stakeholders can understand them and implement them properly. To increase the diversity of standard-setting boards, non-accountants should be encouraged to participate on them.
- **The financial reporting burden on smaller and non-listed entities should be limited.** Standard setters and regulators should consider how they can reduce the burden of financial reporting for smaller and non-listed entities.
- **The use of fair value in financial reporting should be supported.** However, standard setters should better distinguish between the changes to the bottom line that result from changes in fair value, versus those changes that result from the day-to-day running of the business. This would enable stakeholders to better distinguish the true underlying performance of an organization.
- **The application of financial reporting standards should be more principles based** in order to capture the economic substance of a transaction. Professional judgment is needed in applying principles-based standards. Therefore, financial reporting standard setters should provide sufficient room for professional judgment in their standards and regulators should establish a fair enforcement process.
- **Global capital markets would be best served by one set of principles-based, high-quality financial reporting standards**. The increasingly globalized supply of capital necessitates one global set of high-quality financial reporting standards. Education should be provided to promote a swift global transition to International Financial Reporting Standards.
- **Professional behavior and a minimum level of qualification should be required for preparers of financial statements.** In addition, organizations should apply a rigorous recruitment and training approach for their finance and accounting staff.

IMPROVING FINANCIAL AUDITING

- **Audit choice should be increased; organizations should be encouraged to use smaller audit firms.** To further increase auditor choice, regulators should reduce barriers to the growth of smaller auditing firms. Organizations can support the growth of small firms by giving them more business. To offset the danger of collapse or irreparable reputational damage to one or more of the Big 4 firms, the potential sources of catastrophic risk faced by these firms should be monitored, and appropriate safety mechanisms created.
- **Auditors should be supported with additional practice development** to further increase the quality of the services they provide. To meet their main objective—which is not to comply with rules, but to conclude whether or not a financial report provides a true and fair view of an organization's financial performance and condition—auditors need to have the skills and training to exercise professional judgment.
- **The audit profession should consider shifting the focus of its audit reports from conformance to information** to better communicate the stress points in business reports. The audit report should, therefore, move away from standard "boilerplate," and provide more information that was used by the auditors to reach their opinion, such as audit judgments, audit risk assessments, and materiality. To encourage auditors to use their professional judgment, liability apportionment should be introduced.
- **Auditor communication should be improved.** As an alternative to expanding their external audit reports, auditors could provide more discursive board and audit committee reports to enhance the communication between the organization and its stakeholders.

STEPS TOWARD INTEGRATED BUSINESS REPORTING

- **Improving business reporting should start with broadening the stakeholder perspective.** Organizations should be more receptive to the information needs of their various stakeholders and adjust their approach to reporting accordingly.
- **Business leaders should present a cohesive explanation of their organization to help stakeholders assess its overall performance,** which includes how their actions impact the environment. The current practice of reporting should, therefore, be expanded to a more connected way of business reporting, integrating the various social, environmental, and economic aspects of an organization into one cohesive explanation of the business.
- **Management commentary should put the numbers into context.** To provide better insights into what drives the business, management commentary should be more open, transparent, and forward looking. To foster more open narrative reporting, stakeholders should change their approach and culture in regard to litigation.
- **A new, integrated business reporting model should be developed to present a cohesive explanation of the business** so stakeholders can better assess the overall performance of the organization. A high-level, multi-stakeholder integrated report could be connected via information and communication technologies to more detail.
- **More continuous business reporting should be encouraged.** Increasing the frequency and timeliness of business reporting should be encouraged as it would reduce the information vacuum in which stakeholders have to operate. Faster and more frequent reporting also motivates organizations to improve their internal information systems.
- **To remain relevant, auditors should expand the scope of their audits and provide assurance beyond the financial statements.** A redefined, broadened, and more transparent reporting framework will effectively expand the need for assurance, creating new business opportunities for auditors.