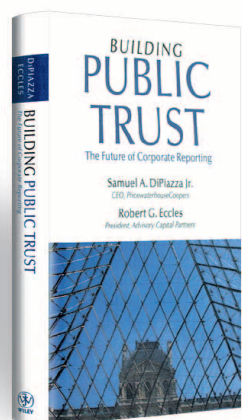


SOUNDVIEW Executive Book Summaries®



By Samuel A. DiPiazza, Jr. and
Robert G. Eccles

The Future of Corporate Reporting

BUILDING PUBLIC TRUST

THE SUMMARY IN BRIEF

The trust of the general public in the capital markets — which is recognized as the foundation of value creation all over the world — has been shaken. The straw that broke the camel's back was the Enron scandal — the largest market cap company to declare bankruptcy. But the signs of serious flaws in the capital markets were already present — from well-publicized business failures to the collapse of the Internet bubble to the decline and volatility of the equity markets.

Enron and other scandals have focused the public's attention on the institutions and people responsible for the information on which investors (as well as lenders, trading partners, customers and employees) depend. Public trust must be restored in this information — and in the purveyors of that information.

This summary offers a model of corporate reporting aimed at restoring that public trust and confidence. The goal of this model is to ensure a spirit of transparency, a culture of accountability and the participation of people of integrity in the corporate reporting process.

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What You'll Learn In This Summary

✓ **The Key Elements Required to Rebuild Trust.** Restoring faith in the Corporate Reporting Supply Chain — which is responsible for supplying the information to investors, analysts and other stakeholders — means rebuilding three key elements that create public trust: a spirit of transparency, a culture of accountability and people of integrity.

✓ **A New Model of Corporate Reporting.** This summary introduces a new model of corporate reporting with three tiers of information: tier one is a Global GAAP; tier two consists of industry-specific standards; tier three consists of guidelines for company-specific information.

✓ **New Technology to Enhance Corporate Reporting.** A new Internet-based application allows information supplied through computers to be more flexible and useful to investors.

BUILDING PUBLIC TRUST

by Samuel A. DiPiazza, Jr. and Robert G. Eccles

— THE COMPLETE SUMMARY

Shaken Confidence: The Crisis In Corporate Reporting

Enron: The name once touted in books and seminars as a company with cutting-edge management techniques and creative strategies is now known simply as the largest market cap company in business history to go bankrupt. The consequences have been enormous: People not only lost their jobs; many of them lost their life savings. And blame is being put not only on the shoulders of top executives, but also on the shoulders of the accountants and lawyers whom the public believes helped them create the house of cards that eventually came crashing down.

Faith in corporate reporting is, perhaps, at an all-time low. Yet, without this faith, the capital markets cannot truly function.

It is time to address this crisis.

The Corporate Reporting Supply Chain

The Corporate Reporting Supply Chain is responsible for supplying the information on which investors (as well as lenders, trading partners, customers and employees) depend to make their financial decisions.

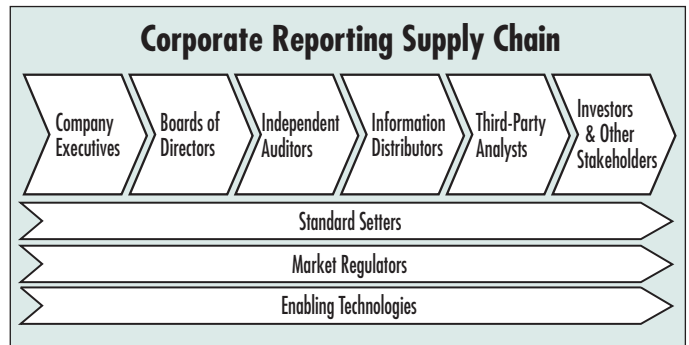
The Corporate Reporting Supply Chain begins with the company executives who prepare the financial statements that are reported to investors and stakeholders. These financial statements are approved by a board of directors, attested to by an independent auditing firm, analyzed by sell-side analysts and broadcast by information distributors, including data vendors and the news media. The entire chain is supported by standard setters, market regulators and enabling technologies. (See chart above).

The time has come to reexamine how the Corporate Reporting Supply Chain works and how it can be improved. Trust in the capital markets depends on faith in the Corporate Reporting Supply Chain — and that faith has been broken.

To restore that faith, corporate reporting reforms must rebuild the three key elements that create public trust in the markets: a spirit of transparency, a culture of accountability and people of integrity.

A Spirit of Transparency

The first key element of trust is a spirit of transparen-



cy. Corporations — that is, the people who work in corporations supported by the corporation's board of directors — have an obligation to provide the information that investors need to make the right investment decisions. Unfortunately, management and boards aren't making the information that they know investors need readily available.

A Culture of Accountability

The second key element of trust is a culture of accountability. Providing information is not enough. The members of the Corporate Reporting Supply Chain must feel a sense of accountability to the other members of the chain. Management, for example, must hold itself accountable to shareholders; it is responsible for using the shareholders' money to create value for those shareholders. The boards must see that this accountability is recognized and maintained.

People of Integrity

The third key element needed for public trust is peo-

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Shaken Confidence: The Crisis in Corporate Reporting

(continued from page 2)

ple of integrity. Despite rules and regulations, processes and best practices, and so forth, the entire structure of corporate reporting collapses if it is not supported by people of integrity trying to do the right thing.

The vision of corporate reporting presented in this summary is based on a new model of corporate disclosure and a fresh view of the responsibility of each link in the Corporate Reporting Supply Chain. This summary also provides suggestions about technology that can support responsible, transparent corporate reporting. ■

A Revised Model of Corporate Reporting

Public trust in corporate reporting — ensuring that investors and other stakeholders get the information they need to make appropriate decisions — cannot exist without corporate transparency. This summary offers a new model of corporate transparency, a three-tiered pyramid-shaped model. The three-tier model of corporate transparency, which is illustrated at right, can be described as follows:

The bottom and widest tier, Tier One, consists of a set of truly global generally accepted accounting principles — in other words, Global GAAP.

The second, middle tier, Tier Two, consists of industry-specific standards of measuring and reporting information — standards developed by the industries themselves.

And finally, Tier Three, the top, narrow third of the pyramid, consists of guidelines for company-specific information — such as strategy, plans, risk management practices, compensation policies, corporate governance and company-specific performance measures.

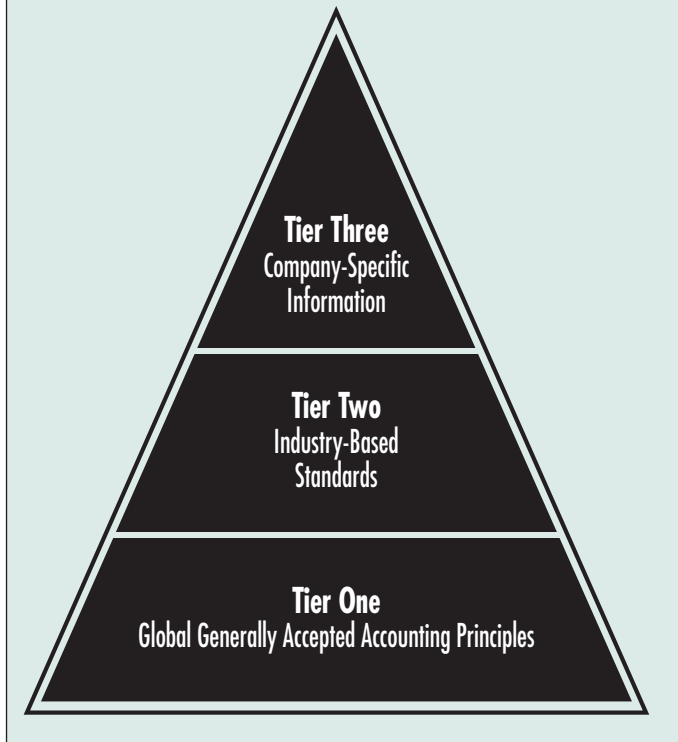
It's important to note that these are not three disconnected tiers; companies must provide the information in each tier in an integrated fashion, so that investors have a holistic view of the company — including the company's strategies, marketplace opportunities, value drivers and, of course, financial outcomes.

Let's take a look at each of these three tiers more closely. ■

Tier One: Standards for Global GAAP

The first tier of the model is global generally accepted accounting principles.

Three-Tier Model of Corporate Transparency



Companies today use a variety of generally accepted accounting principles (or global GAAP), but most of these principles are country-based. In addition, even the best country-GAAP standards are based on the historical cost model that many consider obsolete or, at best, irrelevant in the complex global environment of today's business.

Specifically, criticism about existing GAAP falls into three broad categories. Critics say that existing GAAP:

1. Fosters The Earnings Game (see sidebar on page 4) that is played by both management and the markets.
2. Does not account for or disclose certain types of information about intangible assets.
3. Does not communicate adequate information about value creation because it is a mixed model that includes historical cost, amortized cost, written down cost and fair value for certain financial instruments and other assets in some countries.

The closest one comes to a global GAAP is the International Financial Reporting Standards (IFRS), which by the year 2005 will be mandatory for countries in the European Union.

This is only a beginning, however.

The Case for Global Standards

Capital markets are as global today as product markets. Companies want access to capital from around the

(continued on page 4)

Tier One: Standards for Global GAAP

(continued from page 3)

world. They want to be able to dip into the pools of liquidity offered by the world's exchanges, including the London, Nasdaq or New York exchanges. Companies also want to be able to use their stock to make acquisitions in foreign companies. Today, however, accessing foreign capital markets is expensive and difficult with a global GAAP.

And it is not only companies that suffer the consequences, but investors as well. Global investors are hampered in their decision-making by accounting rules that differ from country to country.

Principles vs. Rules

For global GAAP to work, the people and institutions involved in the Corporate Reporting Supply Chain — from investors to government and regulators — must come to an agreement on the approach for developing standards and the scope of the applicability of those standards.

There are two approaches to developing standards: the rules approach, in which standards are narrowly defined in detail; and the principles approach, in which the standards provide broad guidelines for behavior. U.S. GAAP takes a rules approach, while the current International Financial Reporting Standards (IFRS) exemplify the principles approach.

The problem with the rules approach is that by narrowly defining what companies can do, the standards define what companies cannot do. As a result, companies can stick to the “letter” of the law, while avoiding the spirit of that law (“Hey,” says the accountant of dubious integrity, “nowhere does it say in these rules that I can’t do this!”).

The Right Approach

Global GAAP should be based on principles, not rules. These principles will succeed if they:

- 1. address issues of broad scope;**
- 2. reflect appropriately the economic substance of transactions;**
- 3. ensure that similar transactions are treated similarly;**
- 4. contain few alternatives, exceptions or compromises; and**
- 5. result in transparent and useful reporting and disclosure.**

The principles should be supported by rules only when necessary for clarification. Not everything must be defined specifically.

Transparency and Accountability

The spirit of transparency and a culture of accounta-

The Earnings Game

Many executives believe that the stock price of their companies is dependent on quarterly earnings figures. If quarterly earnings beat expectations, the stock price rises.

As a result of this belief, executives will often play “The Earnings Game.” The Earnings Game involves manipulating figures so that that earnings always beat expectations. For example, they may deliberately understate expected earnings for the next quarter and then benefit when the actual earnings beat those expectations.

Despite the popularity of The Earnings Game, however, empirical studies show that there is actually little relationship between quarterly earnings or net income and stock returns. Enron, for example, played The Earnings Game. For 12 straight quarters (starting with the last quarter of 1998) Enron met analysts' estimates of earnings. In seven of those quarters, Enron's stock went up after the earnings were announced. In five of those quarters, Enron's stock went down.

Earnings are important, of course. But investors need other financial performance measures as well to make their decisions.

bility (for example, company executives should not use general principles as an opportunity for obfuscation, and auditing firms have a responsibility to help their clients provide the best information despite the ambiguous environment) are essential for the success of principles-based Global GAAP. In addition, standard setters and market regulators must be prepared to trust the integrity of managers and accounting professionals rather than constrain their behavior through a myriad of rules.

Accounting Concepts and Convergence Issues

There are fundamental accounting concepts that will need to be addressed and agreed upon to put global GAAP in place. These concepts include whether to value assets at cost or at fair market value; standards for reporting financial performance (for example, standard definitions for some financial measures); standards for reporting intangibles; and defining the reporting entity (for example, identifying the reporting entity in a joint venture).

There are also many categories of standards that differ among major national standards, for example, revenue recognition. A convergence of opinion or approach will be required for these differences.

Despite the challenges of establishing Global GAAP, tier one is on its way thanks to the efforts of the International Accounting Standards Board (IASB),

(continued on page 5)

Tier One: Standards for Global GAAP

(continued from page 4)

which, with the support of national boards and international organizations, is working to make Global GAAP a reality. Of course, the IASB does not have the authority to force companies to use international standards. Therefore, the voluntary participation of national regulators is key. ■

For the six objectives of future Tier One financial statements, go to: <http://mj.summary.com>

Tier Two: Industry-Based Standards

The second tier of the model is industry-based standards. Note that the standards under discussion here are global standards. Industries compete against counterparts from around the globe. In addition, how industries create value for shareholders and the knowledge that industries need to create that value vary widely from industry to industry. Therefore, country-based accounting standards are less relevant and helpful than international industry-based standards.

Global generally accepted accounting principles is a first step in providing international information for investors. However, supplemental information that is industry-specific — information that is both financial and non-financial — is also needed to evaluate completely a company's past performance and future prospects. Supplemental information could include pro forma earnings and free cash flow, neither of which is covered by any form of GAAP. Non-financial supplemental information could include information about intellectual capital or environmental pollution.

Standards Developed by Participants

A fundamental key to the success of tier two standards is that the standards should be developed by the industry participants themselves and should be voluntary, not regulated. Industry participants are not limited to companies; accounting firms, analysts and investors should also be involved in the development of these standards.

It may seem unrealistic to expect standards to be self-developed and self-regulated by companies and industries. However, the current evolution of standards for reporting pro-forma earnings offers an example of the power of voluntary collaboration.

Pro Forma: A Case of Self-Regulation

The reporting of pro forma earnings is controversial because there is no standard definition for what consti-

Information Moving Among the Tiers

Information that is developed for one of the tiers in the Three-Tier Model of Corporate Reporting can find its way to other tiers.

Suppose that Tier-Two industry-specific standards are applicable to a number of other industries, or that different industries develop standards that are similar. In each case, the Tier-Two standards could become Tier-One (Global GAAP) standards.

Tier-Three information — company-specific information — might likewise move to Tier Two. For example, one company might start measuring what it considers to be an important value driver. Other companies in the same industry might see the validity of the new value driver and emulate the first company, but use their own measurement methodologies. Eventually, investors might pressure for industry-wide standards for information on this value driver.

tutes such earnings. The business community has stepped up and expressed concerns about pro forma earnings. As a result, Standard & Poor's has attempted to specifically define what constitutes pro forma earnings, which are differentiated from what S&P calls "operating earnings" and "as reported earnings."

In another development, two professional associations, Financial Executives International and the National Investors Relations Institute suggested jointly in a press release that if pro forma earnings are used, they should be reconciled to GAAP. This suggestion was formally endorsed by the SEC.

Lessons

The discussion over pro forma continues. The point is that standards for reporting pro forma earnings are being developed voluntarily with various participants, offering a model for the voluntary and collaborative development of tier two standards.

The lessons that can be learned from this example — and other examples of voluntary collaboration in the development of standards — are the following:

1. Most initiatives begin with innovations introduced by individual companies.
2. The initiatives offer learning experiences that help identify the best measuring and reporting methods — methods that are then codified into a set of guidelines.
3. These initiatives involve broad constituencies, and rely on voluntary reporting to the guidelines.
4. These initiatives permit some form of independent verification. ■

Tier Three: Company-Specific Information

Tier three of the model consists of guidelines for company-specific information — which can range from corporate strategy and information on a company’s value drivers to the company’s internal control procedures and compensation policies. General guidelines for content and the format for reporting that content should be developed.

A Holistic View

Companies must offer investors a holistic view of the performance of the company. In other words, the various components of the company must be linked, and the company and its markets must be linked. Specifically, the company should demonstrate to stakeholders the links between marketplace opportunities and the company’s strategy; between value drivers and measured results; and between management decisions and value creation.

At the heart of this holistic view of the company are the performance measures of the real value drivers of a company. What are those value drivers?

In a recent PricewaterhouseCoopers survey, executives ranked the following value drivers, which are listed from most to least important for creating value over the long term:

1. Product and service quality.
2. Customer satisfaction and loyalty.
3. Operational efficiency.
4. Current accounting results.
5. Product and service innovation.
6. Employee satisfaction and turnover.
7. Alliances with other companies.
8. Community involvement and environmental performance.

A listing of value drivers, of course, is of limited usefulness. The key is to develop a business model that shows, as mentioned earlier, the links between the value drivers and measured results.

Using the Guidelines

Excellent strategies, well-identified value drivers measured properly and a good business model is not enough to create value for shareholders. This information is a guide to action, but it must be used properly. An effective organizational design, rigorous risk management, sound compliance procedures and corporate governance that truly represents the interests of the company’s various stakeholders are all key

to value creation. The disastrous results of lax corporate governance, for example, have been demonstrated in recent scandals.

Once again, in Tier Three, we find that success depends on the key elements of public trust: transparency, accountability and integrity. ■

Corporate Reporting: The Five Challenges

We close this summary with a look at the five challenges of transparent corporate reporting as required in the three-tier model presented above.

Challenge #1: Model External Reporting on Internal Reporting

The first challenge is to model external reporting on internal reporting. In other words, managers determine

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Executive Perceptions of Eight Value Drivers

Value-driver category	Important for creating shareholder value over the long term	Has a high impact on future financial performance	Use the measure in evaluation and decision making
Product and service quality	89	86	83
Customer satisfaction & loyalty	83	86	73
Operational efficiency	75	75	72
Current accounting results	71	62	81
Product & service innovation	62	60	54
Employee satisfaction & turnover	47	44	38
Alliances with other companies	20	22	17
Community involvement & environmental performance	11	8	11

Note: The figures record percentage of executives who agreed with the statements.

Corporate Reporting: The Five Challenges

(continued from page 6)

that they will report externally the same breadth of information that they use to manage the company internally.

Of course, not all internal information is relevant to external stakeholders. However, companies should begin with the assumption that they will report everything, and then determine why they should not report a certain type of information. If the reasons for not reporting the information are revealed externally — for example, the information would reduce a competitive advantage of the company — external stakeholders will understand and even applaud the decision.

Challenge #2: Determine the Information That Stakeholders Need

The second challenge of transparency is to determine the information that stakeholders need. In addition to identifying this information, management must provide this information in a format that is as useful as possible.

Information gaps — the gap between what stakeholders believe is important for them to know and what companies are willing to provide — exist in nearly every industry. For example, while banking firms are upfront about their market share, earnings and product innovation, they do not provide stakeholders with such important information as market growth, customers and quality of management. Telecommunications companies are especially reticent. Information gaps exist in their areas of market growth, market share, corporate strategy, cash flow, segment information, product innovation, customers and quality of management.

How do you know what information stakeholders believe they are missing? The answer is simple: You have to ask them, either through your company Web site or through surveys.

Challenge #3: Report Relevant Information from External Sources

The third challenge of transparency in corporate reporting is reporting relevant information from external sources. Internal financial information systems cannot provide all of the information desired by stakeholders. External information is needed to explain how the company is performing against industry trends or specific competitors, for example. It's easy, for instance, to trumpet a 10 percent market growth in the past year; the information is more useful, however, when one knows that the industry average was 13 percent growth!

Challenge #4: Report on the Real Economic Entity

The fourth challenge of transparency is reporting on the real economic entity. The Enron scandal illustrates how unscrupulous managers can determine self-serving

In Search Of The Real Economic Entity

What is your company's "real" (as opposed to "official") economic entity? The perimeter of your business isn't as clean and straightforward as you may believe.

For example, a shoe company that outsources its manufacturing might say that those manufacturing partners are not part of the economic entity of the company. Technically, it may be correct, since the manufacturing subcontractors are not owned by the shoe company. However, as one shoe company discovered, a company's brand and reputation can be severely impacted by the activities of a subcontractor.

In addition to subcontracting to low-cost manufacturers, here are some other examples of how a company can expand the borders of its real economic entity:

1. Subcontracting non-manufacturing functions.

For example, high-tech companies will subcontract day-to-day operational activities so that they can lower fixed costs and focus on product development and marketing. However, performance information on these subcontractors is as important to investors as if the firms performed these functions in-house.

2. Selling through distributors. Beverage companies often don't own their distributors. The financial performance of these distributors, however, is still vital in assessing the performance of beverage companies.

3. Outsourcing information technology. A number of companies — especially dot.coms — can outsource their information technology functions to application service providers (ASPs). ASPs, however, became so dependent on these outsourcing contracts, that when the dot.coms went under so did some of the ASPs (much to the dismay of the ASPs' other customers). Do you know who your partners' partners are?

4. Outsource research and development. Large pharmaceuticals, for example, might fund small biotechnology firms to conduct initial research. Information about these smaller firms — including capitalization, intellectual property rights and marketing rights — is important in assessing the pharmaceutical company's return on capital.

definitions of the boundaries of the entity subject to reporting requirements (thus hiding other transactions "outside" the boundaries).

However, determining the real economic entity is not easy; direct relationships with partners can come in many forms, and indirect relationships can be as important as direct partnerships.

The independent board of directors is probably the

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Corporate Reporting: The Five Challenges (continued from page 7)

best decision maker on this issue; it has less self-interested motives to play games with the boundaries than managers might have. Of course, the board must know all the relevant relationships in which the company is involved and understand the dynamics of the value chain of the business.

Challenge #5: Model External Reporting on Internal Reporting

The fifth and final major challenge of transparency is weighing the risks and costs against the benefits. While management may exaggerate the costs of transparency and underestimate its benefits, there are certain disclosures that, in the balance, would be detrimental to the company. There is no formula for calculating the trade-offs between costs and benefits of transparency. Because it is a judgment call, that judgment should be left, once again, to a fully informed board of directors.

When deciding whether or not to disclose information, two principles apply. The first is openness. Disclose as much as possible, and have a clear reason not to disclose information. The second principle is consistency. If you decide to disclose information, continue with the practice in good times and bad. ■

XBRL: Enabling Information Quality, Speed and Usefulness

Reforming corporate reporting does not only involve the content of the information conveyed by the corporate reporting supply chain. The format in which that information is presented is equally important.

In the past, there was no choice in format: It was either paper or nothing. Even in the electronic age, corporate reporting is often no more than electronic versions of paper (for example, the PDF versions of annual reports found on corporate Web sites).

Electronic versions of paper information have the same limitations as original paper documents. For example, if you want to take data from a report and put it into the spreadsheet, you need to manually enter the data in your spreadsheet application — whether you're pulling that information from a paper report or a PDF file. This is problematic not only because it takes more time, but also because it opens a window for errors.

Another problem with information on paper or quasi-paper computer applications is that the readers will get little help in understanding the context of the document — or verifying the information. What you see is what you get — and what you get may not be reliable.

Publishing information on the Internet does have

some advantages; quick access is the most obvious of these advantages.

However, investors and other stakeholders can benefit from a more flexible and complete information transmission system provided by a new Internet-enabled platform called Extensible Business Reporting Language (XBRL®).

XBRL can dramatically improve the quality, speed, usefulness and completeness of the information that companies provide to the public. By tagging every piece of information with a contextual description, XBRL enhances the transparency of the process, and allows investors to validate the reported information in accordance with prescribed standards, such as Global GAAP at Tier One and industry-based standards at Tier Two.

How XBRL Works

XBRL delivers corporate information — or more accurately, data — along with identification tags that allow the computer to place the data in context.

For example, in the past one computer might send another computer data on a company's \$5 million in revenues by transmitting the number 5,000,000. The receiving computer would have to have already been programmed to recognize that number as revenue and to put it in a predefined revenue bin expressed in dollars. With XBRL, no preprogramming is necessary. The data — in this example, the number 5,000,000 — comes with tags that say, "This number is revenues, as defined by Global GAAP number 18, measured in U.S. dollars for a specified period of time for this unique company." The receiving computer allows the information to flow automatically and seamlessly into the right bin.

Investors and analysts can view and use that information as they wish. For example, an investor might automatically compare a company's revenue to its profit, to prior-period revenues or to another company's revenues. Without XBRL, the investor would have to manually take the information and input it into its own analytical software program.

Of course, XBRL is not limited to Global GAAP information. It can tag any kind of information, including the nonfinancial, industry-specific and company specific information at Tiers Two and Three. Users can also capture information anywhere on the Internet and reuse it — including, as in the example above, in an investor's analytical software.

Content is important, but format can be just as valuable in making the information relevant and useful. The XBRL format is an important enabling technology for the future of corporate reporting. ■

For information on a tool to help organize financial information, go to: <http://my.summary.com>