Enhanced Business Reporting: A New Framework for Public Company Disclosure

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Research Note

Institute for High Performance Business

March 2005

Much of today's accounting and regulatory framework in the United States was created in the 1930s in response to the market crash of 1929. To avoid another crash, new rules were put into place to improve corporate governance and the quality of information available to investors. The framework worked well for as long as the industrial economic model prevailed, but with rise of the postindustrial economy and forms of enterprise that employ new business models and rely on new types of resources, it often seems to be hiding more than it is showing.

Public dissatisfaction with the mismatch between industrial rules of disclosure and postindustrial realities has surged in the last decade and half, especially recently in the wake of well-publicized corporate swindles. As early as 1990, however, various stakeholders—including academics, congressional representatives, regulators, and members of the accounting profession—began to express concern over the "growing irrelevance of conventional financial reporting in the new age of information."[1] This chorus has only grown in membership and intensity.

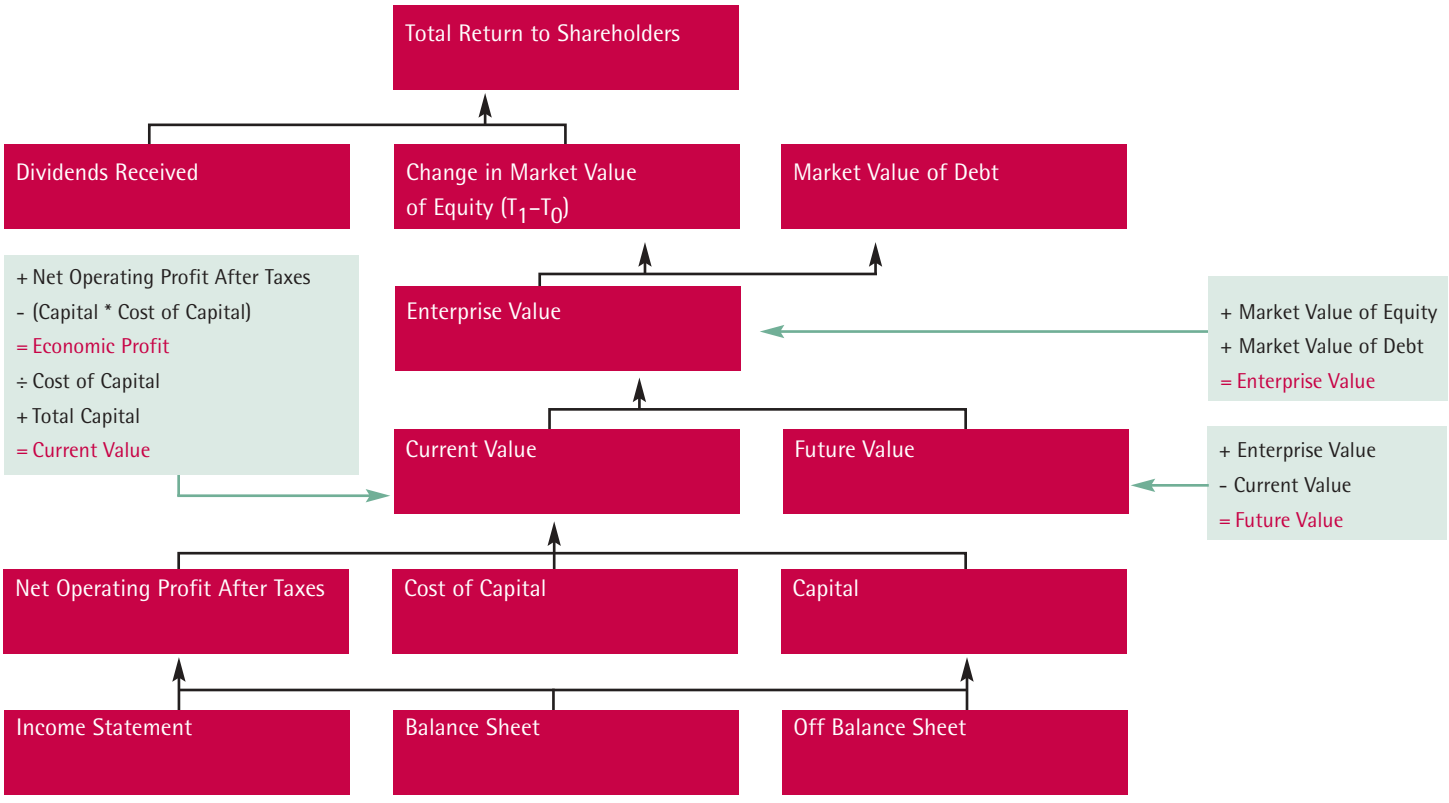
In response, the American Institute of Certified Public Accountants (AICPA) convened a special committee on enhanced business reporting (EBR), asking it to develop a strategy that would "make better information available to investors, creditors and other stakeholders, helping them see an organization through the eyes of management and allowing them to make more informed decisions."[2] The committee is providing guidance to the U.S. Securities and Exchange Commission and other regulatory bodies, along with user communities, on how to clarify the linkage, relevance, and relationship of traditional accounting methods to shareholder value.

Accenture, as part of its ongoing research into the components of high-performance business, has focused on developing new ways for companies to report on their operations. In this instance, Accenture teamed up with AssetEconomics to formally propose an enhanced-business-reporting solution that meets the committee's goals without burying management in the tasks of data collection, calculation, and presentation. In fact, the proposed enhancement requires the addition of only six financial-reporting disclosures and four new statements. Most of the new concepts are already well known and in wide use; for example, total return to shareholders, total economic profit, current value, and future value. By building a systematic exposition that draws these concepts out of traditional accounting and financial terms, the proposal captures what has escaped the older accounting and financial-reporting systems: the increasing importance of intangibles and future value in the composition of shareholder value. (The proposal was subsequently accepted by the AICPA and can be viewed in its entirety at *www.accenture.com/epm*.)

Mapping Total Return to Shareholders

At the core of the Accenture-Asset Economics proposal is the Accenture Total Return to Shareholders (TRS) Mapping Methodology.[3] TRS mapping gives a systematic explanation of both

Exhibit 1: TRS Mapping Methodology



aspects of enterprise value, current and future value, and their relationship to both types of assets, tangible and intangible. It tightly aligns internal financial-performance measures with total return to shareholders in order to accomplish these two goals:

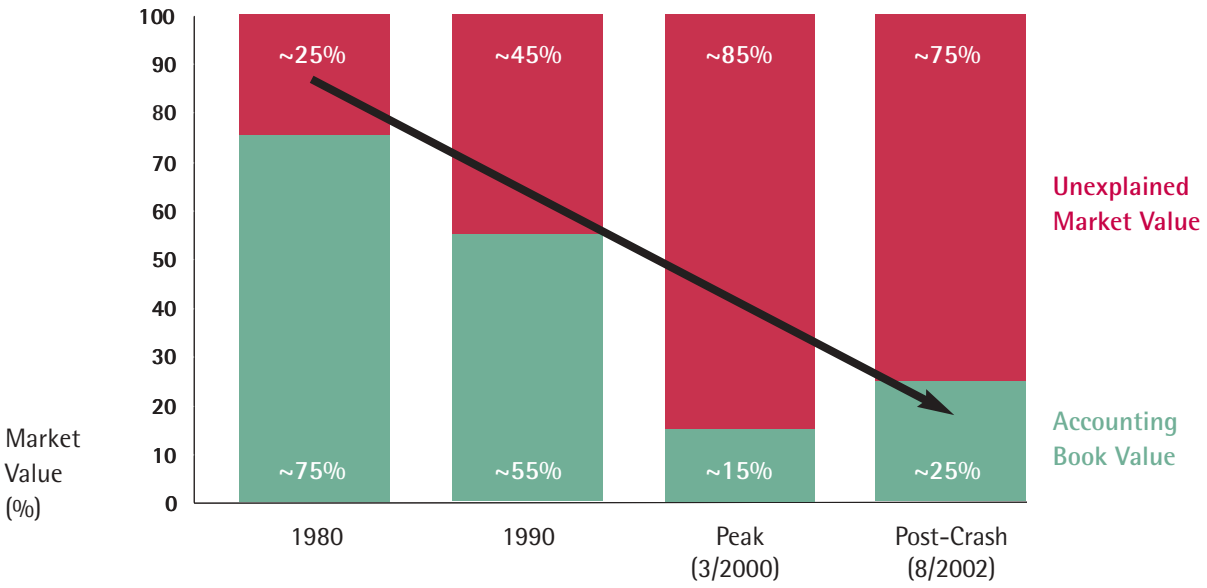
- To clarify and detail 100 percent of a company's valuation by connecting total return to shareholders to traditional financial statements; and
- To simplify the communication and translation of enterprise performance to both internal and external stake holders.

As Exhibit 1 indicates, TRS mapping treats future value on a par with current value. This is crucial, for an Accenture analysis of the Russell 3000 found that only 42 percent of the enterprise value (the sum of the market value of debt and equity) of the U.S. stock market was due to current value (net operating profit after taxes divided by the weighted average cost of capital): $5.5 trillion out of $13.1 trillion. The rest, 58 percent, or $7.6 trillion, is due to future value, or investor expectations of future growth.

Just as current value has become a smaller proportion of enterprise value, book value has come to account for a much smaller proportion of market value. As Exhibit 2 shows, the accounting book value of the S&P 500 declined from 80 percent to 25 percent of market value between 1980 and 2002. Traditional accounting assets, especially because of their reliance on tangible assets, have come to play a much smaller role in the valuation of public companies.

The Accenture-AssetEconomics proposal uses TRS mapping to generate four enhanced-business-reporting statements that complement the four traditional accounting reports (the income statement, balance sheet, statement of cash flows, and statement of stockholder's equity), as displayed on the left-hand side of Exhibit 3.

Exhibit 2: Market to Value Versus Book Value Over Time (S&P 500, 1980-2002)



Sources

Baruch Lev, "Intangibles: Management, Measurement, and Reporting" (Brookings Institute Press, 2001); Baruch Lev, "Remarks on the Measurement, Valuation, and Reporting of Intangible Assets," *Economic Policy Review*, September 2003; Accenture analysis

Only six new disclosures of data are required in order to complete these statements:

1. the calculations and adjustments necessary to arrive at net operating profit after tax (NOPAT);
2. the calculation of invested capital, with adjustments including but not limited to operating leases, goodwill, and stock-option grants;
3. the incorporation of adjustments for off-balance-sheet financing into the market value of debt;
4. the calculation of the weighted average cost of capital (WACC);
5. the calculation of the return on invested capital (ROIC);
6. the disclosure of market capitalization data, especially the methodologies and sources of beta.

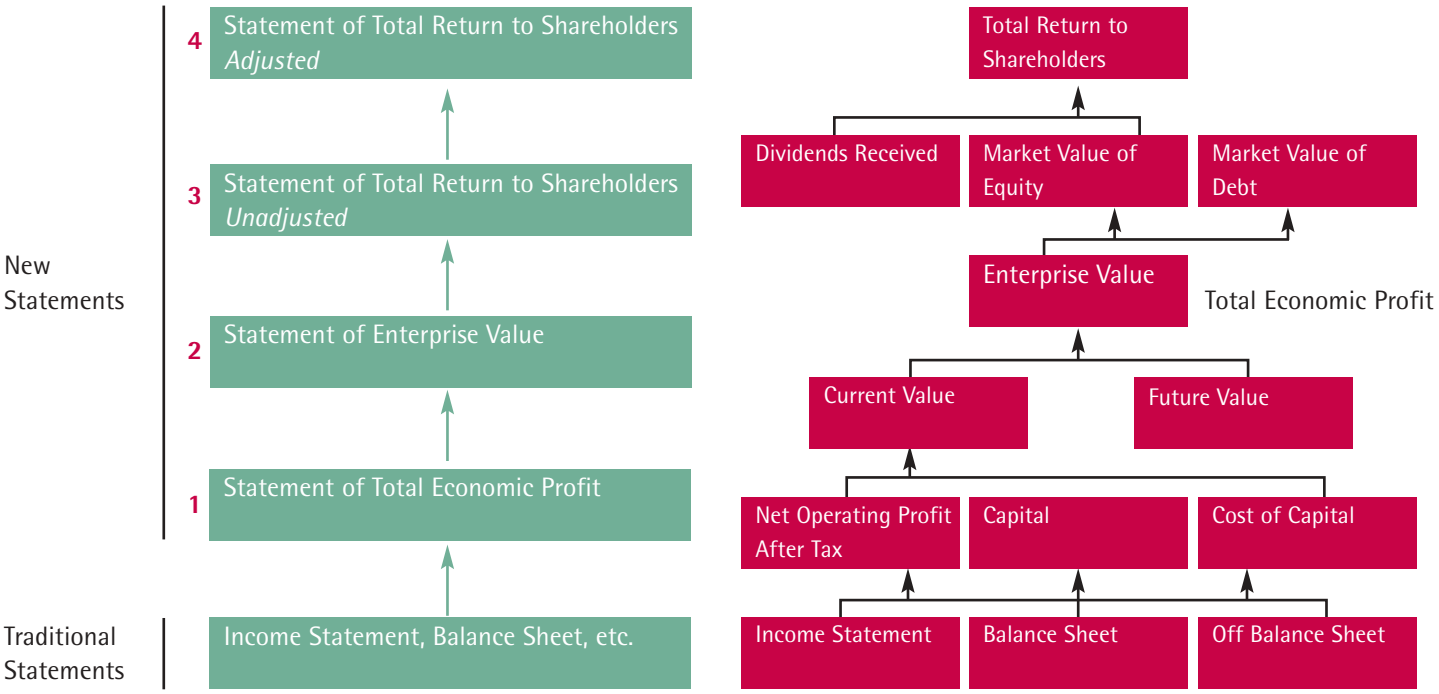
Generating the Four EBR Statements

The Accenture-AssetEconomics proposal requires four additional statements as complements to traditional accounting statements: the statement of total economic profit; the statement of enterprise value; the statement of total return to shareholders, unadjusted; and the statement of total return to shareholders, adjusted.

1. The Statement of Total Economic Profit

This statement starts with earnings before interest and taxes (EBIT) in order to ground enhanced business reporting in traditional financial reporting. (See Exhibit 4. Note that the figures in exhibits 4 through 7 were adapted from the financial reports of an actual company.) To get the economic profit of current value, which is analogous to residual income or economic profit, subtract cash taxes from earnings before interest and taxes to get net operating profit after tax and then subtract a capital charge (the product of invested capital and the weighted average cost of capital). Alternatively, the economic profit of current value can be arrived at by multiplying the spread between the return on invested capital and the weighted average cost of capital by invested capital, as shown in the bottom half of the exhibit. The framework also easily incorporates more advanced definitions of economic profit.

Exhibit 3: EBR Statements and the TRS Map



The economic profit of future value is derived by multiplying the future value (which is analyzed further in the Statement of Enterprise Value) by the weighted average cost of capital. Total economic profit is then the sum of the economic profit of current value and the economic profit of future value and represents the decapitalized cash-flow perspective of enterprise value.

Some additional disclosures may be necessary to calculate cash taxes (since they must be adjusted for interest income, interest expense, operating leases, retirement liabilities, and some other items) and to calculate invested capital, the WACC, and the ROIC.

2. The Statement of Enterprise Value
Once total economic profit has been reported, the enterprise value can be calculated, including the proportions of that figure that make up current and future value. Exhibit 6 illustrates how the market value of equity is computed by multiplying the closing stock price by the closing number of shares outstanding.[4] The enterprise value is the sum of the market value of equity and the market value of debt.

By dividing the economic profit of future value by the weighted average cost of capital, the value of the economic profit of current value into perpetuity is revealed, and by adding to it the invested capital, the current value is determined (or the market's valuation of the current operations of the company; that is, its current cash flows). Subtracting that number from the enterprise value gives the future value, or the market's expectation of future growth (anticipated future cash flows).

Some additional disclosures may be necessary to detail the market value of debt, explaining both on- and off-balance sheet items. We also recommend presenting the debt-to-equity ratio as a supplementary disclosure since changes in the level of debt may have a direct impact on shareholder equity.

3. The Statement of Total Return to Shareholders, Unadjusted
The statement of total return to shareholders calculates the return to shareholders by adding the dividends

Exhibit 4: Statement of Total Economic Profit

XYZ Corporation	For the Year Ended March 31st		
Statement of Total Economic Profit	2004	2003	2002
		Figures in US$ Millions	
Earnings before interest and taxes (EBIT)	$ 1,697.9	$ 1,358.9	$ 1,361.7
Less: Cash Taxes	(656.7)	(529.9)	(536.3)
Net Operating Profit After Tax (NOPAT)	**1,041.2**	**829.0**	**825.4**
Invested Capital	9,857.9	7,721.5	8,047.9
Weighted Average Cost of Capital (WACC)	9.0%	9.5%	9.6%
Capital Charge	887.2	733.5	772.6
Economic Profit of Current Value (EPCV)	154.0	95.5	52.8
Economic Profit of Future Value (EPFV)	1,430.1	1,163.8	1,911.1
Total Economic Profit (TEP)	**$ 1,584.1**	**$ 1,259.2**	**$ 1,963.9**
Additional Disclosure			
Return on Invested Capital (ROIC)	10.6%	10.7%	10.3%
Weighted Average Cost of Capital (WACC)	9.0%	9.5%	9.6%
Spread (ROIC - WACC)	**1.6%**	**1.2%**	**0.7%**

received during the period to the increase (or decrease) in the share price over the same period. It then expresses that total increase (or decrease) as a percentage of the prior year's share price, the total return to shareholders. (See Exhibit 6.) In addition, by adding the value of the economic profit of current value into perpetuity to the capital available to equity holders (invested capital minus capital subordinated to debt), the statement determines the share of current value in the value of equity. By comparing this figure to that for the future value in the market value of equity and, in addition, their respective changes over the prior years, management can begin to figure out what they have been doing right and where they have been less successful. They can then move to allocate resources more productively to shore up weak areas.

4. The Statement of Total Return to Shareholders, Adjusted

The final statement adjusts the TRS figure in accordance with overall stock market movement to isolate the quality of company performance. Exhibit 7 focuses on the S&P 500, though other market indexes could be used, as could peer-performance indexing. The period change in the geographic index is adjusted by the company's beta to yield the expected company return, which is then compared to the actual total return to shareholders to evaluate the company's performance independent of general market trends.

The additional disclosure needed for this statement would be one showing the methodologies and sources used in deriving beta. However, just as with traditional financing reporting, supplemental disclosures and management's discussion and analysis (MD&A) for each of the EBR statements could do much to give a longer-term and more comprehensive economic perspective. They could also do much to remedy a problem that is characteristic of all financial reporting: the role that judgment plays. For example, judgment must be used to decide what data counts as relevant in calculating a company's weighted average cost of capital. EBR supplemental disclosures covering the assumptions, sources, and methodologies behind key calculations can eliminate the element of arbitrariness in judgments and reduce mistrust by analysts and investors. The TRS mapping framework can provide the foundational analyses for such detailed management commentaries and source and methodology analyses.

Exhibit 5: Statement of Enterprise Value

XYZ Corporation	For the Year Ended March 31st		
Statement of Enterprise Value	2004	2003	2002
	Figures in US$ Millions except for Shares		
Closing Share Price of Equity	**$ 58.25**	**$ 45.00**	**$ 55.00**
Number of Shares Outstanding (in Thousands)	324.7	322.0	391.2
Market Value of Equity	18,913.8	14,490.0	21,516.0
Market Value of Debt	8,544.9	6,486.5	6,989.5
Enterprise Value	**$ 27,458.7**	**$ 20,976.5**	**$ 28,505.5**
Additional Disclosure			
Economic Profit of Current Value (EPCV)	$ 154.0	$ 95.5	$ 52.8
Weighted Average Cost of Capital (WACC)	9.0%	9.5%	9.6%
Value of EPCV in perpetuity	1,711.0	1,004.8	550.0
Invested Capital	9,857.9	7,721.5	8,047.9
Current Value	**11,568.9**	**8,726.3**	**8,597.9**
Enterprise Value	27,458.7	20,976.5	28,505.5
Less: Current Value	11,568.9	8,726.3	8,597.9
Future Value	**$ 15,889.8**	**$ 12,250.2**	**$ 19,907.6**
Debt to Equity Ratio	0.45	0.45	0.32

Exhibit 6: Statement of Total Return to Shareholders, Unadjusted

XYZ Corporation	For the Year Ended March 31st		
Statement of Total Return to Shareholders (Unadjusted)	2004	2003	2002
	Figures in US$ Millions except for Shares		
Value of EPCV in perpetuity	$ 1,711.0	$ 1,004.8	$ 550.0
Invested Capital	9,857.9	7,721.5	8,047.9
Less: Capital Subordinated to Debt	8,544.9	6,486.5	6,989.5
Capital Available to Equity Holders	1,313.0	1,235.0	1,058.4
Current Value in the Market Value of Equity	3,024.0	2,239.8	1,608.4
Future Value in the Market Value of Equity	15,889.8	12,250.2	19,907.6
Market Value of Equity	**$ 18,913.8**	**$ 14,490.0**	**$ 21,516.0**
Number of Equity Shares Outstanding (in Thousands)	324.7	322.0	391.2
Close Share Price of Equity Shares	$ 58.25	$ 45.00	$ 55.00
Change in Share Price of Equity Shares	13.25	(10.00)	(4.00)
Dividends Per Share Received	0.4	-	-
Total Return to Shareholders per Share	**$ 13.65**	**$ (10.00)**	**$ (4.00)**
Total Return to Shareholders (Unadjusted)	**30.3%**	**-18.2%**	**-6.8%**

Exhibit 7: Statement of Total Return to Shareholders, Adjusted

XYZ Corporation	For the Year Ended March 31st		
Statement of Total Return to Shareholders (Adjusted)	2004	2003	2002
Closing Geographic Market Index	**1,144.94**	**841.95**	**1,106.75**
Change in Geographic Market Index	36.0%	-23.9%	-11.5%
Beta	0.80	0.80	0.80
Predicted company return due to market movement	**28.8%**	**-19.1%**	**-9.2%**
Total Return to Shareholders (Unadjusted)	30.3%	-18.2%	-6.8%
Better/(Worse) PCT on predicted market movement	**1.5**	**1.0**	**2.4**

Conclusions

The long-term trend toward greater day-to-day volatility in the equity markets has made it difficult for management to come to decisions concerning reporting and disclosure, and for regulators, analysts, and investors to evaluate those decisions. Less apparent, but more important, has been the steady uncoupling of equity value drivers from generally accepted accounting principles (GAAP). As much as $7.6 trillion in U.S. equity value is going underexplained, underreported, and probably undermanaged. Moreover, since many of the investments needed to grow future value are expensed as SG&A and R&D, management is being systematically rewarded for under-investing in future growth opportunities.

The marketplace and interested stakeholders will eventually choose how accounting will answer questions about definitions, procedures, and ways of reporting such frontier accounting issues as intellectual capital, intangible assets, and future value. In the meantime, our enhanced-business-reporting proposal demonstrates that these issues can be addressed by companies seeking to achieve high performance. In a 2001 letter concerning new economy reporting, the SEC's chief accountant wrote to the AICPA: "A characteristic of high-quality financial reporting is that the information is comparable, verifiable, and provided on a consistent basis from period to period."[5] We are confident that the Accenture Total Return to Shareholders Mapping Methodology provides a platform for enhanced business reporting that meets all these criteria in a comprehensive, straightforward, and widely applicable way that can serve both specialists—enterprise managers and institutional investors, for example—and individual investors.

About the Authors

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The Accenture Institute for High Performance Business creates strategic insights into key management issues through original research and analysis. Its management researchers combine world-class reputations with Accenture's extensive consulting, technology, and outsourcing experience to conduct innovative research and analysis into how organizations become and remain high-performance businesses.

Notes

1 Wharton Symposium on Financial Reporting and Standard Setting, Fall 1990.

2 Enhanced Business Reporting Consortium Business Plan, 2004. For more information, see *www.ebrconsortium.org.*

3 See John J. Ballow, Brian F. McCarthy, and Michael J. Molnar, "New Concepts in Value-Based Management: TRS Mapping and Total Economic Profit," Accenture Institute for High Performance Business, May 2004.

4 This figure provides a link between the statement of stockholder equity and the capital markets and is a complement to the SEC disclosure "The Market Registrant's Common Equity and Related Stockholder Matters," which notes only the period's high and low stock price.

5 Financial Accounting Standards Board, "Business and Financial Reporting, Challenges from the New Economy," April, 2001.