



Getting a truer picture of shareholder value

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A consensus is emerging that a new approach to accounting—Enhanced Business Reporting—could significantly improve transparency across all asset classes. It would also meet demands by executives and investors for more science and less art when measuring business performance.

By some measures, Generally Accepted Accounting Principles have surely stood the test of time. Standard accounting practices are doing today exactly what they were intended to do—provide information on a company's historical performance and measure traditional asset classes. Trouble is, GAAP was designed in the 1930s, and in the years since the US Securities & Exchange Commission established the Office of Chief Accountant, both the economy and the way corporate performance is measured have changed dramatically. Intangible assets—such as a company's brand or intellectual capital—and expectations for growth have become important drivers of shareholder value; neither is taken into account through traditional GAAP analysis.

According to GAAP, the key measures of business performance are net income and earnings per share. Yet there is a limited—and diminishing—correlation between those measures and share prices. A company's income statement usually accounts for only about 4 percent of market value for a stock with a typical price/earnings ratio of 25, while the balance sheet covers about 25 percent. The remaining 70 percent of market value consists of intangible assets and expectations of future growth (see "Future value:

The \$7 trillion challenge," *Outlook*, February 2004).

This inability of GAAP to account for a significant percentage of value represents enormous exposure, and not only for investors. It also means that a company's leadership team is now responsible for important value-creating assets that are underrecognized, underreported and, in fact, undermanaged.

Executives and investors alike are looking for a new set of tools

to address this problem by improving reporting. The C-suite wants a reporting framework that can more clearly communicate its goals and its performance against those goals to investors. It also wants to standardize the increasingly divergent languages of its management team, investors and analysts. Stakeholders, for their part, want the increased transparency that would result from getting more accurate, appropriate information in the reports they receive.

Financial accounting and management accounting diverged some time ago. To actually run the enterprise, the C-suite uses financial management tools to track product and segment profitability, complete activity-based costing analyses, or capture intercompany pricing. The results of these activities rarely appear in formal financial reporting. Outside the enterprise, the company's most sophisticated followers, such as buy-side analysts, rely increasingly on their own analytics, which are often based on proprietary valuation algorithms. Yet despite this divergence, public companies dedicate two and a half months of effort every fiscal year to preparing ever more detailed 10-K reports (or their non-US equivalents) that cover diminishing portions of the enterprise value.

EBR is not a replacement for GAAP but a complement to it. And it will not be overly burdensome for companies.

And what is covered in those reports can punish a company for pursuing goals that enhance shareholder value. Consider such classes of intangible assets as brands, skilled human capital and proprietary networks.

Intangible assets are basically created by investing in the future, which in current reporting terms means such sales, general and administrative (SG&A) costs as training and education, software development, research and salaries. Under GAAP reporting, SG&A expenses are a line item that is subtracted from revenues; as these expenses increase, earnings per share typically decrease. Therefore, current reporting frameworks actually encourage companies to underinvest in the future—that is, the frameworks discourage the kinds

of investments that could add the most shareholder value.

A number of recent initiatives have begun to address these reporting issues. Conceptual frameworks such as Economic Value Added (EVA), Cash Flow Return on Investment and the Balanced Scorecard are all attempts to provide more relevant information. The proliferation of non-GAAP supplemental disclosures—EBITDA is a good example—are also ways that companies are trying to improve disclosure.

A consensus is emerging that a new approach, called Enhanced Business Reporting (EBR), could help respond to these needs. EBR is not a replacement for GAAP (or its non-US equivalents) but a complement to it. The goal of EBR is to significantly enhance transparency across all asset classes.

At least one coalition of concerned participants, the Enhanced Business Reporting Consortium, is attempting to reach preemptive, formal agreement on basic conceptual standards (see sidebar, page 52). Accenture has developed an approach that it has proposed to the consortium for consideration. The approach is based on widely accepted principles such as total return to shareholders (TRS), total economic profit (TEP), and concepts of current and future value. It would have the additional benefit of not being overly burdensome for companies.

A new approach

The first step in the approach is to divide a company's assets into five categories: monetary, physical, relational, organizational and human. Each of these asset types is then further broken down into tangible and intangible assets. Tangible monetary and physical assets are the ones

Asset classification framework

The framework divides company assets into five categories: monetary, physical, relational, organizational and human. It then divides them into tangible and intangible. By defining the categories, it becomes clear what is currently being measured by the traditional accounting system (shown in orange) and what is not (shown in blue). All of the assets listed below drive shareholder value. But most of them are not being tracked by traditional accounting systems.

- Tracked by traditional accounting systems
- Not tracked by traditional accounting systems

		Asset type				
		Traditional accounting assets		Intellectual capital assets		
Asset recognition	Tangible	Monetary <ul style="list-style-type: none"> Cash Investments Receivables Payables Compensation benefits including long-term incentive schemes (including option schemes) 	Physical <ul style="list-style-type: none"> Property, plant and equipment Inventories (raw materials, WIP, finished and goods) Stranded assets Physical work environment 	Relational	Organizational <ul style="list-style-type: none"> Documented systems Documented processes Access rights Patents Brands Mastheads Management contracts Employee contracts Employee development and training programs Performance management systems Customer lists Customer contracts Supplier contracts Formal alliances 	Human
	Intangible	<ul style="list-style-type: none"> Credit ratings Accruals Balance sheet strength Cash flow volatility 	<ul style="list-style-type: none"> Plant location 	<ul style="list-style-type: none"> Stakeholder support Preferred status Organizational reputation Rights to tender, to design, to participate Networks Regulatory imposts 	<ul style="list-style-type: none"> Organizational structure Culture 	<ul style="list-style-type: none"> Leadership Problem solving ability Work environment (interaction) Recruitment and selection Career paths Rewards and recognition capabilities Employee satisfaction Employee retention Employee relations Knowledge (including tacit) Functional skills Experience

SOURCE: ASSET ECONOMICS



generally tracked with GAAP. None of the other assets—including things such as patents, credit ratings and leadership—appear on the typical balance sheet (except as part of goodwill following an acquisition).

By defining all the assets, it becomes clear how much of the company is not currently being measured. Including all types of assets provides a complete understanding of all of the drivers of shareholder value (see chart, page 51).

The next step in our recommended approach is to create four new disclosure statements. These are built by supplementing traditional accounting data with six new calculations.

1. Net operating profit after tax (NOPAT)
2. Weighted average cost of capital (WACC)
3. Return on invested capital (ROIC)
4. Adjustments for off balance sheet financing, to be incorporated into the market value of debt
5. Disclosure of market capitalization data, specifically methodologies and sources of beta
6. The calculation of invested capital, which may have significant adjustments that include but are not limited to operating leases, goodwill and possibly stock options

These calculations are then used to create the four new disclosures that help explain corporate performance with specific emphasis on the returns delivered to shareholders by fiscal year.

1. Statement of TEP: derived by calculating earnings before interest and taxes, then subtracting cash

A consensus approach to change

The consortium approach to EBR is being propelled, in part, by a sense that only a multi-interest effort can secure marketplace endorsement of EBR solutions equal to the perceived crisis. The approach is also being driven by a collective desire to keep any changes consistent with the ongoing convergence of US and international GAAP.

The Enhanced Business Reporting Consortium was conceived by the Special Committee on Enhanced Business Reporting (SCEBR) of the American Institute of Certified Public Accountants (AICPA) in recognition that the accounting profession alone cannot reinvigorate business reporting. Participants in these conceptual discussions include US and European regulators, professional organizations such as the AICPA, trade organizations such as Britain's CBI, the buy- and sell-side analyst communities, accounting and consulting firms, and financial analysts. Entities such as the Financial Accounting Standards Board and the International Accounting Standards Board, the National Investor Relations Institute and NASDAQ are providing additional input. (Accenture is a member of the SCEBR).

The Enhanced Business Reporting Consortium does not intend to produce a single, orthodox EBR methodology. Rather, its aim is to create a common conceptual platform, from which a number of different supporting methodologies and best practices might emerge, and be accepted on a market-driven, voluntary basis.



Statement of total economic profit

Links total economic profit with traditional financial reporting by starting with earning before interest and taxes (EBIT)

XYZ Corporation \$ millions For the year ended March 31st			
	2004	2003	2002
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%

Statement of enterprise value

Shows the market-based value of the company and relative split between current value and future value

XYZ Corporation \$ millions except for shares For the year ended March 31st			
	2004	2003	2002
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

taxes, then subtracting an additional capital charge (consisting of WACC multiplied by invested capital) (see page 53).

2. Statement of enterprise value: calculated by adding the market value of equity and the market value of debt (see page 53).

3. Statement of TRS, unadjusted: determined by adding dividends paid during measurement period to an increase in share price during same period (see below).

4. Statement of TRS, adjusted: derived by calculating performance relative to geographic market indices such

Statement of total return to shareholders—unadjusted

Shows amount of money an equity investor made during the time frame

XYZ Corporation \$ millions except for shares For the year ended March 31st	2004	2003	2002
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%

Statement of total return to shareholders—adjusted

Shows amount of money an equity investor made during time period relative to geographic market index

XYZ Corporation For the year ended March 31st	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

as the S&P 500, FTSE or Hang Seng (see page 54).

Aligning spirit and letter

The accounting profession has reached junctures like this before. GAAP itself was created in response to the Great Depression to restore the confidence of the investing public after the breakdown of the global financial system. While we do not foresee a similar crash, the current de-linking of financial performance and market value needs to be addressed.

Of course, stakeholders will need time to adjust to any new business reporting system. There needs to be considerable debate before stakeholders can agree on how to classify intangible assets and how they should be reported. And discrete stakeholder interests will maintain their own priorities in terms of ideal reporting formats.

Given its emerging conceptual foundation and its links to current accounting, we think the eventually agreed-upon EBR framework will be strong enough to accommodate all these factors. As long as methodologies and data sources are adequately disclosed, both sophisticated and basic users of EBR will have more science and less art in making decisions about shareholder value.

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