

Research article

The Necessity of Improving Reporting Quality With a view of reporting non-financial measures (An Analytical Study)

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Abstract

There is an increasing trend for businesses to produce information on social, environmental and sustainable aspects of their operations. Although guidelines exist for the production of such reporting, and legal requirements can be found in some countries, their use is often optional and the disclosure of non-financial information is mandatory only in limited cases. Companies may find it in their interest to disclose voluntarily certain non-financial information ,particularly if it is designed as part of a package to improve their credibility and acceptance in key markets, or if it enables them to undertake business more successfully. In sectors dominated by large multinational enterprises, disclosure of such information may be seen as an important business driver. This paper is an analytical study that examines whether the use of non-financial information is important in company reporting. **Copyright © IJEFF, all rights reserved.**

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1. Introduction

Prior studies suggest that higher-quality financial reporting should increase investment efficiency (e.g., Bushman and Smith,2001; Healy and Palepu, 2001; Lambert et al., 2007). Consistent with this argument, Biddle and Hilary (2006) found that firms with higher-quality financial reporting exhibit higher investment efficiency proxied by lower investment-cash flow sensitivity. However, investment-cash flow sensitivity can reflect either financing constraints or an excess of cash (e.g., Kaplan and Zingales,1997, 2000; Fazzari et al., 2000). These findings raise the further question of whether higher-quality financial reporting is associated with a reduction of over-investment or with a reduction of under-investment.

Non-financial performance measures are becoming an important type of disclosure in the corporate environment as evidenced by calls for more of this type of disclosure by organizations such as the Enhanced Business

Reporting Consortium (EBRC, 20 05) and the Institute of Chartered Accountants in England and Wales (ICAEW, 2003). Non-financial performance measures are based on measures that complement financial statements such as “operational measures on customer satisfaction, internal business processes, and the organization’s innovation and improvement activities”(Kaplan and Norton, 1992,p. 71). Based on the above topics, in this study we examine whether the use of non-financial information is important in company reporting.

2. Non-financial information

This type of information can be defined as “all information disclosed outside the financial statements issued by the company” (Robb, Single, & Zarzeski, 2001). Non-financial information comprises all quantitative and qualitative data on the policy pursued, the business operations and the results of policy in form of outcome, without a direct link with financial registration system. It refers to information that falls outside the scope of mainstream financial statements. It is a basis of providing direction. It does not have direct financial impact. Sometimes non-financial information could refer to social accounting, corporate social responsibility (CSR), environmental reporting, sustainability, service performance reporting and etc. While non-financial reporting is currently voluntary, it offers significant benefits to organizations in terms of stakeholder engagement and reputation. Proposals to supplement conventional accounting with the use of nonfinancial information (NFI) have exerted a powerful appeal in recent years. Balanced scorecards and similar performance measurement systems have been advocated intensively and are widely used by organizations (e.g., Eccles et al. 2001; Kaplan and Norton .2001).

One apparent characteristic of this information is that it is unsuitable for standardization. Although the form of these disclosures can be standardized, the substance of the disclosure is not easily standardized. Traditionally, information considered relevant for users of business reports have been standardized and mandated, resulting in a uniform reporting of balance sheet, income statement, cash flow statement, and statement of changes in owners equity. The information items included in these reports are universal in that they are applicable for all firms and more or less relevant for users of each firms report. The inevitable question is, therefore, whether companies can be trusted to identify and disclose critical information to the market. So far, we have heard the Jenkins Committee insist that their proposed non-financial information disclosures are relevant, and there are studies testing the disclosure of such information by firms, but it is not known whether this information is useful to one of the primary users of financial information, namely sell-side financial analysts. The work of financial analysts includes collecting and interpreting information in order to predict future performance and stock returns of target firms. Analysts can be seen as both complements and substitutes for firm disclosed information; for instance, De Franco (2004) found that analysts were mainly substitutes for firm disclosures. This observation indicates that one role of analysts is to sort out useful from non-useful information and communicate a summary of the useful information to their clients, the investors.

3. Financial and Non-financial Performance Measures

Non-financial performance measures are frequently used for performance evaluation; specifically, they are a central element of concepts such as the balanced scorecard . From an incentive point of view non-financial measures can be helpful because any combination of costless performance measures that reduces the risk imposed on the agent through an incentive contract is beneficial to the principal. Furthermore, combining different per-formance measures may help the principal in inducing specific activities, and thereby to reduce managerial myopia (Kaplan and Norton,1992). Non-financial performance measures such as customer satisfaction, product quality, or employee turnover are especially relevant in cases where market-based performance measures showing the total firm value are not available. This is true for the division of a firm, or when the firm is not listed on a stock market. Then, the director or owner of the firm can only use accounting-based and non-financial data for performance evaluation and management compensation (Bushman and Indjejikian ,1993).

Generally, non-financial measures have no intrinsic value for the director. Rather, they are leading indicators that provide information on future performance not contained in contemporaneous accounting measures. Empirical studies by Ittner et al. (1997) (qual-ity – growth in profit margin), Ittner and Larcker (1998a) (customer satisfaction –future accounting performance), and Banker et al. (2000) (customer satisfaction – future accounting earnings) support the role of non-financial performance measures as a leading indicator of future financial results. Such leading indicators are especially necessary for performance measurement and

management compensation when current managerial actions influence the firm's long-term financial return but are not reflected in the contemporaneous accounting measures. Examples refer to delaying costly maintenance activities at the expense of the future availability of the machinery and, therefore, a lower future financial return.

4. Non-financial measures and accounting

Many of the accounting research provides evidence that selected NFI can be used both to substitute for and to complement accounting information in tasks for which accounting is typically important, such as forecasts of future financial performance or evaluation of current performance. Accounting and NFI work together as a portfolio of measures, in which the value of using and refining accounting measures depends on the information properties of NF measures included in the portfolio, and the information value of any specific NF measure depends on the properties of accounting. In consequence, the accountant's tasks depend on the properties of NFI as well as of accounting information. For example, in Amir and Lev (1996), accounting earnings alone appear irrelevant to stock prices for wireless communication firms; but when NF measures of growth potential are included in the model, earnings become significantly value relevant. Similarly, in performance evaluation and reward systems, accounting earnings that are imperfect measures of employees' actions can be *more* heavily weighted (i.e., more dollars of reward can be provided for a given increase in earnings) when appropriate NFI is also included in the reward base (Feltham and Xie 1994; Datar et al. 2001). Prior studies suggest that higher financial reporting quality can improve investment efficiency by reducing information asymmetries that give rise to frictions such as moral hazard and adverse selection. We extend this research by documenting the channels by which financial reporting quality relates to investment efficiency.

5. Reporting non-financial information

Information is always reported in conformity with a specific frame of reference that presents the criteria or standards for the valuation, classification, and presentation of the information. Insofar as this framework relates to the presentation of information in a report, it is referred to as accounting principles. Financial reporting has gone through a long period of development, and generally accepted accounting principles are available for it. Examples include national standards issued by the Dutch Accounting Standards Board and international standards, such as International Financial Reporting Standards (private sector) or International Public Sector Accounting Standards (public sector). With nonfinancial information, the quality requirements for the information and the way in which it is presented are not uniform. Only limited professional rules of conduct for auditors in this information field have been developed. The debate on reporting and providing assurance on the information is in its early stages.

Theoretically, accounting information is becoming less relevant if it fails to include some intangible values in the balance sheet. Because firms are increasingly relying on intangibles for their future success, this accounting treatment has meant a gradually decreasing relevance of accounting information (Wallman, 1995; Lev and Zarowin, 1999). The criticism has centered on the argument that business reports have been lagging as opposed to leading, which is what users are looking for. In a measure to solve this problem the AICPA Board of Directors commissioned the Jenkins Committee in 1991 to "recommend (1) the nature and extent of information that should be made available to others by management and (2) the extent to which auditors should report on the various elements of that information" (AICPA, 1994, p. 2, Appendix IV). Having developed and executed a study designed to better understand the information needs of investors and creditors, the Jenkins Committee Report, published in 1994, contained recommendations on business reporting. The report suggests that to meet the needs of users, business reports must: (a) Provide more information with a forward-looking perspective, including managements plans, opportunities, risks, and measurement uncertainties. (b) Focus more on the factors that create longer term value, including non-financial measures indicating how key processes are performing. (c) Better align information reported externally with the information reported to senior management to manage the business (AICPA, 1994, p. 5).

6. Principles of non-financial reporting

A sustainability report should address all material (i.e. relevant and significant) issues affecting stakeholders. Both GRI-G3 and AA1000APS provide a selection of principles to be considered when reporting on sustainability. These include:

Inclusivity: AA1000APS states that "inclusivity is much more than a stakeholder engagement process". It outlines it as the commitment to be accountable to those stakeholders that the organization impacts and those stakeholders who have an impact on it. It also enables their participation in identifying issues and finding

solutions. In the words of Account Ability: "It is about collaborating at all levels, including governance, to achieve better outcomes."(AA1000APS2008). **Materiality:** An issue is considered "material" if it will influence the decisions, actions and performance of an organization or its stakeholders. GRI-G3 defines materiality as "the topics or indicators reflecting an organization's economic, environmental and social impacts that would influence the assessments and decisions of stakeholders."(Global Reporting Initiative Sustainability Reporting Guidelines, 2007).AA1000APS defines materiality as "the analysis of information which takes into consideration sustainability drivers, and accounts for the needs, concerns and expectations of the organization and its stakeholders."

Responsiveness: Defined in AA1000APS as "how an organization demonstrates its response and accountability to its stakeholders." A responsive organization addresses its material issues and responds to its stakeholders in a comprehensive and balanced manner.

Stakeholder inclusiveness: Similar to responsiveness, the GRI-G3 states that "the reporting organization should identify its stakeholders and explain in its report how it has responded to their reasonable expectations and interests."

Completeness: According to GRI-G3, "completeness is the coverage of the material topics, the GRI-G3 indicators and the definition of the report boundary which sufficiently reflects economic, environmental and social impacts, enabling stakeholder assessment." While completeness is no longer an explicit AA1000 principle in the revised 2008 edition, it remains a key concept to the extent to which materiality inclusivity and responsiveness have been achieved.

7. consequence of reporting voluntary non-financial information

The major consequence of reporting voluntary non-financial information seems to be a reduction in the information asymmetry (Lang and Lundholm, 2000; Brown, Hillegeist, & Lo, 2004; Guo, Lev, & Zhou, 2004), which leads to a reduction of the risk of investing in the reporting company. This diminished risk in turn improves the liquidity of the companies' shares (Healy, Hutton, & Palepu, 1999; Leuz and Verrecchia, 2000). Consequently, more efficient investment decisions can be obtained (Gray, Radebaugh, & Robert, 1990). Another benefit appears to be a decrease in the firms' cost of capital (Welker, 1995; Francis, Khurana, & Pereira, 2005). Sengupta(1998) documents that a policy of timely and detailed disclosures results in a decrease of the cost of debt for the company. Botosan (1997), Botosan and Plumlee (2002), and Hail (2002) demonstrate that an increased reporting of voluntary information in annual reports is associated with a lower cost of equity. Healy and Palepu (1993) further suggest that financial analysts are more convinced about the reliability of mandated information when companies also disclose voluntary information. Moreover, financial markets continue to demand more information in order to make investment decisions (Grüning&Stöckmann, 2004; Kristensen and Westlund, 2004).

7. Conclusion

Nowadays non-financial performance measures have long been argued to reflect underlying economic resources and activities that are not reflected by financial performance measures. In this study we examine whether the use of non-financial information is important in company reporting. Non-financial measures offer four clear advantages over measurement systems based on financial data. First of these is a closer link to long-term organizational strategies. Financial evaluation systems generally focus on annual or short-term performance against accounting yardsticks. They do not deal with progress relative to customer requirements or competitors, nor other non-financial objectives that may be important in achieving profitability, competitive strength and longer-term strategic goals. For example, new product development or expanding organizational capabilities may be important strategic goals, but may hinder short-term accounting performance.

By supplementing accounting measures with non-financial data about strategic performance and implementation of strategic plans, companies can communicate objectives and provide incentives for managers to address long-term strategy. Second, critics of traditional measures argue that drivers of success in many industries are "intangible assets" such as intellectual capital and customer loyalty, rather than the "hard assets" allowed on to balance sheets. Although it is difficult to quantify intangible assets in financial terms, non-financial data can provide indirect, quantitative indicators of a firm's intangible assets. Third, non-financial measures can be better

indicators of future financial performance. Even when the ultimate goal is maximizing financial performance, current financial measures may not capture long-term benefits from decisions made now.

Finally, the choice of measures should be based on providing information about managerial actions and the level of "noise" in the measures. Noise refers to changes in the performance measure that are beyond the control of the manager or organization, ranging from changes in the economy to luck (good or bad). Managers must be aware of how much success is due to their actions or they will not have the signals they need to maximize their effect on performance. Because many non-financial measures are less susceptible to external noise than accounting measures, their use may improve managers' performance by providing more precise evaluation of their actions. This also lowers the risk imposed on managers when determining pay.

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