Introduction to ValueReporting™

Good afternoon, Mr. Chairman and members of the Committee.

My name is Ellen Masterson, and I am a partner with the independent accounting and auditing firm of PricewaterhouseCoopers (PwC, the Firm). My specific role within the Firm is serving as the Global and US Leader of Assurance Methodology, and as the Global Leader for ValueReporting. ValueReporting™ is an approach to performance measurement and corporate reporting, developed by PricewaterhouseCoopers, to help companies meet the information needs of the capital markets, and is the topic about which I have been asked to speak with the committee today. I thank you for this opportunity.

By way of background, I joined the Firm in 1973 and, after a short leave-of-absence to complete my MBA at Southern Methodist University in 1978, and became a partner in the Firm in 1985. My area of greatest experience is in the financial services industry, primarily in the insurance sector, although through my career, I have served as an auditor for clients in a variety of businesses. In 1997, I left the Firm to become the Chief Financial Officer of American General Corporation, based in Houston, Texas. I returned to PwC after two years and have had successive roles in assurance service innovation and methodology in the US and on a worldwide basis, including my involvement with ValueReporting.

PricewaterhouseCoopers L.L.P. is a professional services firm of 48,000 partners and employees offering accounting, auditing, tax and management consulting services to a wide variety of private and public sector clients in approximately 100 U.S. cities. Through its international affiliates, it serves clients in 150 countries.

I first became aware of the ValueReporting initiative of PricewaterhouseCoopers while I was with American General, and my response to the thought leadership going on in the firm was that it was “right on point”. So, when I was asked to become involved in this

initiative after returning to the Firm, and in particular to bring the perspective of a former CFO to the discussion, I was pleased to do so. It was shortly after I became involved that, in the summer of 2000, we began work on the book about which I have been asked to speak with you today – ***The ValueReporting Revolution, Moving Beyond the Earnings Game***, published by Wiley in February 2001. The named authors of the text are Dr. Robert G. Eccles, a former tenured professor at the Harvard Business School and currently a Senior Fellow of PricewaterhouseCoopers; Robert H. Herz, one of my partners whom I am sure you are aware will assume the leadership of the FASB on July 1 of this year; E. Mary Keegan, a former PricewaterhouseCoopers partner who now serves as Chairman of the UK Accounting Standards Board, and David Phillips, one of the initial ValueReporting thought leaders in our firm from London. As indicated in the foreword, the impact of my own personal contribution to the writing of the book was primarily to assist these authors in understanding just how difficult it can be, in practical terms, to achieve greater transparency from the corporate reporting perspective. With two of our authors either serving, or about to be serving, as the leaders of the UK and US accounting standards making bodies, respectively, we hope the recommendations contained in the book will receive greater attention.

I have included with my written testimony today a Book Summary prepared by getAbstract, a company that specializes in business book summaries, as well as a summary of "frequently asked questions" that can be helpful in understanding the basic concepts promoted in the text, and perhaps some of your own queries that we might not get to today. What I would like to do here is to highlight the major concepts that I believe the committee would find of interest in light of the recent spotlight on the subject of transparency– recognizing that at the time of our writing of The ValueReporting Revolution, Moving Beyond the Earnings Game, the topic of transparency was not as "vogue" as it is today.

In the early 1990's, our firm became interested in exploring the effectiveness of corporate reporting in meeting the needs of investors and analysts around the globe. Research

began on a country-by-country basis, and after 14 country surveys of investors, analysts and management (primarily CFO's) regarding the information that each group believed was most important to the creation and assessment of long-term value, a clear picture had emerged. There was great consistency across country borders, demonstrating that investors in most parts of the world were interested in much the same information, and that their information needs were not being met by current corporate reporting practices.

From this extensive research of over 1000 investors and analysts across the 14 countries, we also learned that:

- 33% of companies believed that they were undervalued in the market place;
- investors and company managers had a surprisingly consistent view on what information is important;
- managers, for a variety of reasons, felt unable to communicate more than is demanded by the regulatory model;
- despite the widespread use of corporate reports in the investment community, less than 30% of both investors and analysts regarded them as useful;
- the market is excessively focused on short-term earnings; and
- companies would benefit significantly, in the opinions of investors and analysts surveyed, by improving their disclosure practices, including higher share prices where warranted.

Out of this research, PwC drew two significant conclusions:

1. The perceived gap between management's view of a company's value, and the market valuation can be explained, at least in part, by a lack of relevant, credible information in the marketplace. I will come back to this "gap" analysis in a moment.
2. The information that the marketplace wants and needs can be codified in what we call "the ValueReporting Disclosure Model", covering the information that all three groups – investors, analysts and managers – agreed was important to understanding the long-term value creation potential and activities of a corporation.

First, let me address the communication gaps, which we believe contribute to investors' placing an incorrect value on a company today. This assumes a rational market, which in the presence of 100% of the information needed, would appropriately arrive at the value of the enterprise, based on future cash flows discounted at a reasonable rate of expected return for the business risk involved.

From our research, we defined five underlying communication gaps driving the Value Gap between management's assessment of value and the market's assigned value. A graphical depiction of these five underlying gaps is found in Exhibit 7.4 on page 130 of the book. In brief, the five underlying gaps are as follows:

The Information gap: investors want information about the performance of the company that they are not receiving

The Reporting gap: management recognizes that there is important information about the performance of the business that they are not reporting

The Quality gap: while management agrees certain performance information is important, they either don't have the information or they have it but are not comfortable that it is of adequate quality for public dissemination.

The Quality Gap often underlies the Reporting Gap: management doesn't report information because they don't have it, or don't believe it is of sufficient quality for external reporting.

The above are the three most significant gaps underlying the Value Gap.

The good news is that the other two gaps are of less significance:

Understanding gap: investors/analysts and management differ on the importance of information

Perception gap: management believes they are communicating the information more or less than investors/analysts believe they are getting it.

It is truly significant that these gaps are small, because it means that outsiders and insiders are fairly well aligned on what information is important, and how well it is currently being communicated.

The most troublesome gap described above is the Quality Gap. After much consideration of the reality that internal information used by management is often not subjected to the same level of rigor and control that is ascribed to publicly disseminated information, we concluded that our recommendations to close the Value Gap by reporting more relevant information externally could actually lead to Better Managed Companies. This follows the adage, "you can't manage what you can't measure". If external reporting will improve the quality of internal measures, then higher quality measurement can actually improve the quality of management.

So, let's move to the kind of information that causes the Information Gap for investor/analysts, remembering that, by and large, managers agree this information is important but not communicated. The ValueReporting Framework emphasizes four categories of information needed for investors, analysts and managers to fully understand the value of the enterprise:

1. Overview of the **Markets** in which the company operates
    - Competitive Environment
    - Regulatory environment
    - Macro-economic environment
2. The Company's **Strategy** for creating value for the investor
    - Goals
    - Objectives
    - Governance
    - Organization
3. How the Company **Manages for Value**

Financial performance metrics
Financial position measures
Risk management practices
Segment performance

4. The **Key Drivers of Value** in the Company's Business Strategy
   Innovation
   Brands
   Customers
   Supply Chain
   People
   Reputation
      Social
      Environmental

After these initial conclusions, at the request of two of our clients in the insurance and banking industries, respectively– we began to conduct similar research by industry sector, and different results began to emerge. Today, after completing 8 global industry sector research surveys of investors, analysts and companies, with 6 more in various stages of progress, we have compiled industry-specific versions of the ValueReporting Framework which differentiate primarily among the value drivers that carry the greatest importance in different industries. The four categories of the Framework have held true, but within each category, the key performance indicators and the drivers of value will differ. In ***The ValueReporting Revolution, Moving Beyond the Earnings Game***, we highlight the results of one of those industry surveys, the High Tech industry, to demonstrate how the Framework can be used in practice to improve corporate disclosures to investors and analysts, increasing the relevancy of the overall information flowing to the capital markets.

So, if investors, analysts and managers all agree that there is important information needed to fully value companies today that is NOT being communicated in the marketplace by management, why don't they do something about it? There are likely many answers to this question, for example, the following:

- It's not required.
- It's competitive information that should be guarded.
- The information on non-financial value drivers, if used internally, isn't as reliable as it should be (i.e., Quality Gaps are real).

- By the time we get through complying with the complex accounting rules and requirements of US GAAP, the last thing we have time to do is sit back and ask ourselves, "what do investors really need to know?"
- Who else is doing it? We don't want to go first.
- There are no standards for this kind of information, so what good would it be anyway?
- The more we disclose, the greater our exposure to legal liability, particularly if it is forward-looking information, and we miss our targets.

We recognize the arguments, we've heard them all by now. And, yet, we haven't met a CEO or a CFO who doesn't basically agree that the results of our research make basic sense, and believes that, eventually, the market will probably approach something like we are recommending. And, there are some global companies who are leading the way. In our ValueReporting Forecast 2002, we showcase examples of 61 companies in 17 countries, which we have identified as "best practices" in the various categories of the ValueReporting Framework. We are currently at work on Forecast 2003, which I am certain will show even greater progress in voluntary disclosures by leading edge companies who see the value in transparent reporting.

So what is this value? In the spirit of transparency, we have no conclusive and incontrovertible evidence that better disclosure will lead to more "accurate" stock prices. We should also note that the real point is performance, not transparency per se. However, better disclosure of lousy performance will likely lower a company's stock price; better disclosure of good performance will likely raise it. That said, intuition and financial theory both say that increased transparency decreases risk to investors, and we have persuasive evidence from our country and industry-based surveys of analysts and investors that better disclosure offers some clear benefits. The results of these surveys suggest that the most important benefits of greater transparency to companies are: (1) increased management credibility, (2) increased management accountability, (3) more

long-term investors, (4) greater analyst following, (5) improved access to and lower cost of capital, and (6) more accurate share prices.

But not all the benefits accrue to the companies who choose to pursue ValueReporting. There are benefits to investors as well. Simply put, ValueReporting would give investors the information they need to make better investment decisions. Of course, this really only applies to investors who take a reasonably long-term view. It is doubtful that day traders and momentum investors will care much about ValueReporting. But investors who want to know whether a company is performing well along the value drivers that will produce a return in the future should be great champions of ValueReporting. Our research indicates that investors will reward those companies that practice ValueReporting with a lower cost of capital, because of the lower uncertainty discount that will result from better information.

So, with all these benefits, why does it take a revolution? As I said, I have attached a Frequently Asked Questions section, but this particular question, I would like to address here.

The reason we believe a revolution in corporate reporting will be needed to achieve the objectives of ValueReporting is that it is based on a philosophy of complete transparency, requiring dramatic changes in management and board behavior which will be fueled by powerful new technologies, and at the same time challenges the existing regulatory regime by bringing more relevant information to the marketplace on a voluntary basis.

In recent hearings, the Committee has looked at the role of the board and the audit committee in corporate reporting and corporate governance. The board has the ultimate responsibility for representing shareholders' interests–and that includes clear communication from management in order to realize the true value of their investment. It follows, then, that the board is responsible for making sure that ValueReporting happens. The board also needs the kind of information that ValueReporting provides to properly evaluate the management team. And the board has a responsibility to make sure that the

investors, whose interests it represents, get such information as well. Just as senior management needs the information for running the company, so does the board need it to perform its role.

The audit committee can play a key role in ensuring that relevant information about tangible and intangible assets is developed, including information about the relationship between risks taken and return realized. If the audit committee accepts responsibility to oversee "information" and not just "financial information," it positions itself not only to protect the company from downside risks, but also to support management's pursuit of the upside. This enables the audit committee to take a broader view of risk as well and to ensure that information about the company's risk management practices explicitly articulates the risks being taken in the pursuit of value, what the expected value is, and how the downside will be managed.

With heightened awareness of the need for greater transparency in corporate reporting, I would like to also give the committee an update on our continued thought leadership in this area at PwC. In 2000, we called for industry-based voluntary disclosure, which others, such as the FASB were also promoting. In light of recent occurrences, however, we do recognize that the groundswell for standard setting in this area is being accelerated.

We continue to believe that this should be driven by industry-based coalitions, globally organized in responding to investor needs. We also do not believe that the historical financial reporting model should be expected to incorporate all the information needed by those participating in the capital markets. In this age of easy access to real-time information, we encourage the preparers and users of information in the capital markets to create new venues for reporting the information that is important to the proper valuation of companies, stretch the boundaries beyond traditional financial reporting and open their minds to a greater sharing of information about the real drivers of value in the business with those whose capital management deploys. Information partnerships between the suppliers of capital and the users of capital should be the goal.

Thus, we do not propose that ValueReporting will make traditional financial reporting less relevant. High-quality historical financial information delivered on a timely basis remains critically important. But the traditional financial reporting model neither meets investors' *complete* information needs, nor does it support today's market valuations. Neither are we advocating putting lots of intangibles on the balance sheet. Thinking in terms of the balance sheet misses the real point. What the market wants is *information* on intangibles. We don't advocate a lot of changes in existing accounting rules or adopting new ones to accomplish this – in fact, we favor simplification of accounting rules and consideration of an international principles-based approach for reporting historical results.

For the additional information the market needs, we simply say that companies should give the market reliable and relevant information, and the market will figure out what to do with it. Investors need more, and more meaningful, information than they now get. Companies should supplement their GAAP-based financial statements with timely, equally high-quality nonfinancial information. Analysts already run non-GAAP information—provided by companies, or estimated through their own research—through their models to make recommendations to investors. If investors lose money, however, they often include the GAAP accountants and auditors among the culprits. It's in our interest as professional auditors and accountants, as well as in the interest of companies and their shareholders, to make sure that all reported information is relevant and reliable for end-users. If companies and investors ultimately hold us accountable for that anyway, we might as well do it up front.

Before I conclude my remarks, I would be remiss if I did not address in brief the subtitle of the book: ***Moving Beyond the Earnings Game***. It was no surprise that our market research confirmed what every participant in the capital markets already knew: the market is too obsessively focused on short term earnings, which has caused management to spend too much time managing expectations when they could be managing their businesses for greater value over the long term. The Earnings Game, as outlined in the text, follows seven rules:

1. Deliver a track record of consistent earnings growth
2. Manage earnings expectations carefully
3. Slightly beat earnings expectations
4. Make business decisions to meet or beat expectations
5. Hammer stocks that fail to meet expectations
6. Listen carefully for the whisper number
7. Hammer stocks that fail to meet the whisper number

The energy of top management expended in this cycle each quarter is energy that could be put to better use in crafting strategies that benefit long-term value-based investors. The Game is Real.

One of the consistent themes in all of our firm's country-based and industry-based research is that investors need more information about the Quality of Management. One might question how companies can better communicate this particular driver of value. Certainly it is not reduced to a simple metric. Or is it? Isn't that what the market uses the Earnings Game for? In the absence of other, long-term information about management, the markets they choose to operate in and their strategies for growing the value of investor's hard-earned money, short-term earnings will continue to be used as a proxy for how reliable management is in feeding the Earnings Game.

Our book was intended to be provocative, and hopefully, my remarks have been as well. For those of you who read the full text, you will see that we have been fairly critical of all those who participate in what could be called the "corporate reporting supply chain" – from management and the board, to the auditors and the analysts. We all have a role to play, and it must start with properly reporting and analyzing the historical performance of the business in the prevailing GAAP model. We must also push beyond the boundary of regulatory reporting in order to meet investors' needs for additional information, and provide all relevant information needed to inform the capital markets, with a strong rigor for quality.

I appreciate the opportunity to be with you today and to share some of the results of our research, our interpretation of these results in the area of improving corporate reporting, and I would be pleased to answer any questions from the members of the committee.

I have structured the following portion of my written testimony as "Frequently Asked Questions and Answers" which we have found to be an efficient way to present information on this topic. I would encourage members of the Committee to read our book, ***The ValueReporting Revolution: Moving Beyond the Earnings Game*** for a more detailed understanding of the underlying research and methodology.

I. ValueReporting in General

1. **What is ValueReporting?**
   ValueReporting is an approach to performance measurement and corporate reporting, developed by PricewaterhouseCoopers that helps companies be more appropriately valued in the capital markets. It addresses the gaps between the current financial reporting model and the demand by investors and other stakeholders for more information on market dynamics, strategy, and the intangible, nonfinancial drivers of shareholder value. ValueReporting provides greater clarity and transparency to investors and other corporate stakeholders and supports better decision making by managers.

2. **What are the key components of this approach?**
   An important part of the overall concept of ValueReporting is the ValueReporting Framework. This framework has four major elements that provide a comprehensive way for a company to evaluate and structure its communications to the market:
   (1) Market Overview describes competitors and their competitive positions, assumptions about the macroeconomic environment and industry growth, views on the regulatory environment, and perceptions about current and future technologies.

(2) Value Strategy describes the company's overall corporate strategy and its strategies for major business units, as well as how the company intends to implement these strategies in terms of organization and governance structures and processes.
(3) Managing for Value describes the measures the company believes most closely reflect inputs to and changes in shareholder value, actual income statement and balance sheet results compared to targets and benchmarked against competitors, segment information, and information on risk and risk management.
(4) Value Platform provides information on the critical value drivers in the company's strategy, typically the leading indicators of future financial performance, including innovation, intellectual capital, customers, brands, the supply chain, people, and reputation.

3. **What information beyond the company's own performance does ValueReporting take into account?**
A lot of variables other than the company's own intrinsic performance can affect its stock value, the investor's ultimate interest. For example, strong operating results will likely have a lesser effect on stock price if all the company's major competitors did even better. Similarly, industry conditions—growth rate, margin pressures, new competition for example—and macroeconomic conditions—such as growth rate, inflation rate, and exchange rates—can also significantly affect stock prices. Management should report explicitly its own views and expectations about such external factors and how they will affect their company's and their competitors' performance. Clearly, the latter involves providing information on competitors, through benchmarking for example. Although investors can find virtually all this external information themselves if they are willing to expend enough effort, ValueReporting argues that management serves its own best interest by presenting a complete, coherent picture and shaping the message the market hears.

4. **How does ValueReporting differ from other models that provide evaluations of stock price?**
There are various financial models in the market for evaluating a company's stock

price and how management decisions can affect it. They are typically based on financial measures such as sales growth rate, cash tax rate, cost of capital, fixed investment efficiency, capital investment efficiency, time period of positive yield returns, and working capital investment efficiency. These models focus specifically on value creation, while ValueReporting takes a much broader view. It addresses the company's business model—versus a pure financial model—and includes both financial and nonfinancial value drivers. It also emphasizes the importance of reporting this information both internally and externally. Although ValueReporting culminates in value realization, it is integral to the activities that lead to value creation and value preservation.

Another approach in the marketplace is called Value Dynamics, which focuses on internal decision making to improve value creation. Reporting this information externally is something of an after-thought. ValueReporting quite explicitly focuses on how companies can realize their appropriate value in the capital markets by reporting more and better information to shareholders and other stakeholders. Still, ValueReporting has its foundation in a robust internal performance measurement system—the first step in implementing the new reporting model—that will improve internal decision making as well. Furthermore, the discipline of external reporting should improve internal decision-making—you can't manage what you don't measure, as the saying goes. ValueReporting, therefore, opens up a positive feedback loop to value creation as well.

5. **What in your mind makes ValueReporting so critical? What problems will it solve?**

   Traditional financial measures provide less and less of the information that the markets consider important in determining stock prices, particularly over the long term. Of critical importance, but missing from traditional financial reporting, is adequate information on intangible assets and the nonfinancial value drivers that are leading indicators of future financial success. Although executives recognize this and

have made good progress in improving their internal performance measurement systems—through "balanced scorecards" for example—they have changed very little in what, how much, and the way in which they report information to the market. The internal evolution in performance measurement requires a corresponding external revolution in corporate reporting for stakeholders to realize the full value of the company. After all, if managers find such information useful in making value-creating decisions, the market will also find it useful in evaluating just how much value has been and will be created. This will help solve the problem of inaccurate stock price valuations. Better information will also reduce volatility by lowering investor risk through a better understanding of small deviations between actual earnings and carefully managed earnings expectations and "whisper numbers."

6. **Is ValueReporting only relevant for publicly listed companies?**
   No. ValueReporting begins with better internal management decisions. This is as important to private companies as it is to public ones. Furthermore, private companies often have investors (e.g., venture capitalists), lender (e.g., banks) or other stakeholders that will find the information that results from ValueReporting as useful as shareholders in publicly traded companies do.

7. **Does ValueReporting offer particular benefits in certain situations?**
   Although ValueReporting has relevance to *all* companies, it proves especially beneficial in circumstances when: (1) the market significantly under- or over-values a company, (2) a company experiences a sudden decline in market value not justified by the underlying economic reality, (3) a new CEO or CFO wants to diagnose and improve how the company communicates with the market place, (4) the market needs help in understanding the implications of a major M&A transaction, and (5) a newly listed company needs to build awareness and credibility in the capital markets.

8. **Will "perfect" information result in "perfect" markets?**
   Of course not. The information companies report will never be perfect. It can, however, become a whole lot better than it is. Even if perfect information existed,

structural features in the markets—such as momentum investors, day traders, and rumors and gossip—introduce a certain element of irrationality regardless of how much high quality information companies provide for strategic investors. In reality, even though executives can strongly influence stock prices by providing more information, factors beyond their control will always affect their company's market valuation.

9. **Does the relevance of ValueReporting vary between bull and bear markets?**

ValueReporting has relevance in both types, but it takes on particular importance in bear markets. When companies can no longer rely on a simple, strong earnings growth story, and the rising tide lifts all ships, executives have a stronger incentive to provide as much information as possible to help raise their stock price. They also have a different view of the risk/return equation in providing such information. Because their stock is already down, providing more information has a greater upside benefit than downside risk. In a bull market, however, executives tend to feel that more information will actually depress their stock price—particularly if they believe their stock is overvalued, which few really do. ValueReporting isn't a silver bullet that can prevent a company's stock from declining in a bear market, but if a company practices ValueReporting, and the market has more information about a company, we believe that company should fare better than competitors that don't practice ValueReporting.

10. **Isn't ValueReporting really just about the New Economy? What does it have to do with Old Economy companies?**

As long as intangible assets and nonfinancial value drivers are important, so is ValueReporting. Although intangible assets may have less importance in Old as compared to New Economy companies, nonfinancial value drivers certainly don't. For example, all companies have customers, market share, employees, and such. Furthermore, as the distinctions between Old and New Economy companies continue to blur, New Economy metrics are quickly becoming relevant to all. Even Old Economy companies, in the insurance industry for example, acknowledge the importance of innovation, brands, and customer service in building shareholder value.

This is especially the case for high-achieving companies.

II. Global Issues

11. **How does ValueReporting play out around the world?**

Very well. Issues like valuation and volatility apply to any stock market. That said, basic financial reporting is better developed in some markets than in others. Certain Asian and many nascent capital markets must still work hard on getting the basics right in terms of financial transparency; they have to do this before they can seriously pursue ValueReporting. However, priorities differ around the world. U.S. companies emphasize shareholders and the realization of value in the capital markets. European countries have more openly embraced the triple bottom line approach, discussed in Question 18, with its expanded emphasis on the larger, more diverse issues of all stakeholders.

12. Don't European companies already practice many of the principles that ValueReporting espouses?

Some certainly do, often driven by a greater concern in Europe than in the United States for other stakeholders. But because the issues that other stakeholders care about overlap so much with the nonfinancial value drivers that shareholders care about, satisfying the information needs of other stakeholders takes companies farther along the path of ValueReporting.

III. Corporate Reporting in General

13. **Should companies start practicing "real-time" reporting?**

If you mean, "Should companies report information soon after management receives it?" the answer is “yes.” How frequently management gets any particular information is a function of how often it is important in managing the company, and the costs and benefits of speed. The faster management needs information, the sooner the market should get it. Management already gets and uses certain types of information on a real-time basis—orders, shipments, and reject rates for instance. Investors might find such information useful as well in valuing their future potential return on a real-time basis.

14. **What is "triple bottom line" reporting?**

The triple bottom line refers to achieving balance in how a company performs in three areas: economic, social, and environmental. These areas are typically considered to be the foundation for "sustainability." The proponents of sustainability say that in order to create long-term economic value, including long-term shareholder value, companies must perform well and deliver acceptable results against all three triple bottom line measures. Furthermore, once they have created this value for both shareholders and other stakeholders, sustainability calls on companies to report their triple bottom line performance. Royal Dutch Shell, a company cited extensively in *The ValueReporting Revolution*, has totally embraced this concept. In *The Shell Report 2000*, for example, the company reprinted a report signed by both PricewaterhouseCoopers and KPMG verifying "health, safety, and environmental statements and graphs" and statements and data "relating to the systems and processes Shell has put in place to manage social performance."

15. **How does ValueReporting relate to the triple bottom line?**

ValueReporting embraces the concept of the triple bottom line, although it does not require companies to adopt it. Rather, ValueReporting calls on them to identify all relevant stakeholders and to make sure their information needs are met. If a company uses a multi-stakeholder model, it should incorporate the principles of ValueReporting in its triple bottom line reports. Executives should also explicitly articulate their views about the relative importance and relationships among different stakeholder needs.

16. **How far will companies have to go in terms of disclosure?**

The core philosophy is the spirit of transparency: If information is good for management, it's good for the market. This philosophy stands in stark contrast to the prevailing practice where companies report only what regulation requires, and then report more only as compelled to do so. ValueReporting advocates starting from a position of complete transparency (i.e., all indicators used by top management to assess and manage the

performance of the business) and then ratcheting back to deal with sensitive competitive information or performance measures that lack enough reliability to be put into the public domain. How far companies will go depends on how quickly they embrace this philosophy of complete transparency and realize its benefits. While we can't predict how far and how fast companies in general, let alone any particular company, will go in this direction, we can confidently predict that doing so puts them on a one-way street. The future is all about greater transparency. There is no turning back.

17. **Should the financial reporting rules change as well?**

    Some change would be a good thing. Our research indicates that there is little, if any, variation in the information needs of investors on a country-by-country basis, indicating that we truly are operating in a global capital market, where information is concerned. Most important, therefore, having a truly global set of international accounting standards would be quite useful. Short of this, getting as much reconciliation among the International Accounting Standards Committee and the major national standard setters would be helpful. Simplifying the incredible complexity of U.S. GAAP would be a good place to start.

18. **How much and what types of risk does ValueReporting require companies to disclose?**

    Risk is a central aspect of ValueReporting and an area where companies have a lot of work to do. First, executives should recognize the three dimensions of risk: opportunity, hazard, and uncertainty. Second, they should develop valid measures and strategies for each. Third, they should report on all of them to the market in an integrated way. This means that instead of discussing in very different places the opportunity aspect of value creation (in the MD&A section of the annual report, for example) and internal and external hazard risk that can destroy value (in the 10K, for example), management should present information on both together. This should include the upside of the risks being taken, the downside and how the company is managing it, and the level of certainty that management has about its estimates of

both the upside and the downside.

IV. Companies, Executives, Boards

19. **How many companies really practice ValueReporting today?**
It depends on the definition of "practice". If we are referring to "companies that are approaching complete transparency" as described in our book, *The ValueReporting Revolution*, the answer is probably none. If we mean "companies that are beginning to voluntarily provide a lot of other value-relevant information they aren't required to report," the answer is "more and more." While we can't give you an exact number, you may wish to review the *ValueReporting Forecast 2001* and the *ValueReporting Forecast 2002* for some interesting examples.

20. **What are some examples of where ValueReporting has actually had a direct impact on a company's stock price?**
The answer to this question builds on the previous two answers. Because there are no examples of companies that have fully embraced ValueReporting, its direct impact on stock price simply can't be verified empirically. But remember, ValueReporting reflects more than PricewaterhouseCoopers' thinking on corporate reporting. It also reflects the findings of rigorous research in which both companies and investors agreed that better disclosure would contribute to the proper valuation of stocks. Finally, some recent independent empirical research, including a study by three Harvard Business School professors, has shown statistically significant relationships between greater transparency and higher stock prices. Interestingly, research done on the Singapore Stock Exchange showed that more frequent disclosure of the same information (i.e., historical results) can actually lead to greater stock price volatility, while a broader disclosure of performance based information has the opposite effect.

21. **What are some specific examples of measures that companies should report in practicing ValueReporting?**
Such measures fall into categories like customers, innovation, human capital, and

brands. They also tend to be somewhat industry-specific, and company-specific, based on a company's unique strategy for value creation. But to give you a concrete example, here are seven measures that high-tech company executives, analysts, and investors all agree are important, just as they agree that the market isn't getting much information on them: strategic direction, market growth, quality/experience of the management team, market size, competitive landscape, speed to market (first to market), and market share. If a high-tech company aggressively provided information on these measures—along with earnings, cash flow, and gross margins—it could be said to be practicing ValueReporting.

22. **Are companies naturally resistant to ValueReporting?**

Yes. Voluntarily increasing disclosure to the market, let alone to other stakeholders, is an unnatural act for many executives. They will focus more on the downside than the upside in doing so. Like any other major innovation in management practice, ValueReporting's early detractors will vastly outnumber its early advocates. This is particularly true of ValueReporting. It's not an experiment, like reengineering, that companies can test away from the market's eyes and reveal only if the results are good. ValueReporting requires revelation. Based on our research results, companies that are performing well and that step forward first into the ValueReporting arena will reap benefits. They will also exert enormous pressure on their competitors to follow suit. What will analysts and investors do when they can get more value-relevant information from a company's competitors but not from the company itself? We rather doubt this will be to the non-reporting company's advantage because, in the absence of such information, the perceived risk to investors will be higher. The thing for us to keep in focus in speaking with clients about ValueReporting is that it is ultimately about reducing investor risk—thereby reducing the theoretical or practical discount rate that savvy investors apply to future values, resulting in higher current valuations. It's not about reporting *better* results—but *actual* results, whatever they are, as a means to achieving better valuation through lowering risk.

23. **How quickly are companies actually put ValueReporting into practice?**
It is not happening overnight, although the current environment has opened many eyes relative to the possibilities for greater in transparency. Most companies should anticipate a three-year program of getting their internal measurement act together, figuring out what shareholders and other stakeholders want to know, developing reliable measurement methodologies, using this new performance measurement information to run the company (thereby testing its validity), and then starting to report more information to the market. This, of course, is a never-ending process, but within three years most companies will legitimately be able to say that they are practicing ValueReporting.

24. **Will companies have to develop new "systems" to practice ValueReporting?**
There are really three "systems" kinds of things that need to happen. First, companies can simply recalculate information that already exists in their current systems, for example, financial measures of intangible assets. Second, they will need to develop systems that pull together data that already exist, but which reside in disparate systems, such as when many divisions do business with the same customer; when customer penetration is a significant driver of value; and when management, therefore, needs to know total customer penetration, sales, or profitability. Third, they will, at some point, need to develop new measurement methodologies, often with new IT support, for such measures as customer retention or market penetration.

25. **Can ValueReporting actually put companies at greater risk of liability and litigation?**
It depends. Obviously companies in the United States face the greatest risk. There, executives should use the appropriate Safe Harbor disclaimers, especially when providing "forward-looking information" or information that could be construed as such. We can't promise, however, that this will suffice. As long as there are lawyers, there will be lawsuits. Better Safe Harbor legislation would certainly help. Even so, we believe that while downside risks certainly exist, the potential upside benefits more often than not justify taking the risks. Furthermore, as companies report more

information, investors must assume more responsibility for using it wisely.

26. **Does the relative importance of ValueReporting vary across industries?**
Yes. While the basic principles of ValueReporting apply across all industries, some can reap especially large benefits. In general, this applies to any industry in which there are large market-to-book ratios and/or where the information that managers use to run the company differs significantly from what they report to the market. ValueReporting is least applicable to very Old Economy, hard asset, commodity, non-branded industries where the traditional financial reporting model remains quite relevant. After all, traditional financial reporting was developed when such Old Economy companies were the New Economy companies at that time. Nonetheless, some Old Economy companies, such as General Electric, have successfully leveraged intangible assets like brands and people as important dimensions in how they create value. For such companies, ValueReporting has as much importance as it does for New Economy companies.

27. **What implications does ValueReporting have for highly diversified firms?**
Each distinct business should have its own distinct "ValueReport" because the most important nonfinancial measures will vary business-by-business. And even when those measures are the same, they will be based on different methodologies and therefore will not "roll up" into a single, consolidated, corporate-level number. The only measures that roll up are the financial ones. Some have come to refer to it as segment reporting "on steroids".

V. Institutional and Individual Investors

28. **Will ValueReporting actually enable individual investors to make better investment decisions?**
We think so. Many individual investors have already proven themselves to be sophisticated consumers of the information that they currently have available to them, both from the companies themselves and from other sources. The possibility does

exist, of course, that individual investors will be overwhelmed with the amount of information ValueReporting will make available to them and won't really be able to make sense of it. On the other hand, this creates an obvious opportunity for savvy enterprises to provide assistance in the form of software, individual advice, research reports, and more. If such analytical assistance will help individuals make better investment decisions, they will be willing to pay for it.

29. **What effect will ValueReporting have on day traders?**
In an immediate sense, none. Day traders don't really care about value. Over time, however, greater transparency should result in less volatile markets and diminish day traders' arbitrage opportunities, because stock prices will respond less to rumors and gossip and more to information about real performance.

VI. Standards and Regulators

30. **Does ValueReporting imply that regulators are really regulating the irrelevant?**
No, just that they are not regulating all that is relevant in terms of the overall value ascribed to companies today and, therefore, the additional information investors need. Regulators still have a useful role to play in financial reporting, although we are on record supporting less complex regulations, particularly with respect to U.S. GAAP.

31. **Should regulators require companies to report on nonfinancial measures?**
This may well happen, but we need to move carefully down this path. We believe that the first step is industry-based initiatives to identify the relevant nonfinancial measures and to develop the best methodologies for measuring them. Leading companies, acting in their own self-interest and in the interests of their shareholders and other stakeholders, will start reporting this information, and standards will evolve. Analysts and investors will demand more of this information, and companies will have to respond to these market forces. Already the U.K. Accounting Standards

Board and the AICPA are looking at the possibility of recommending other measures for companies to report to the market. At the time we wrote *The ValueReporting Revolution,* the failure of Enron had not yet occurred, and calling for expanded reporting as a requirement would have been foolhardy; today, it is more likely to happen if standard setters reflect on the contribution of transparency to investor protection and move in this direction.

32. **Should standards be developed? If so, who should develop them and how?**
Eventually standards will be needed to enable investors to compare "apples and apples" the way they do with financial measures. The best way to develop standards is through industry-based consortia that include executives, accounting firms, analysts, investors, and other experts. Once standards have been developed and broadly adopted by an industry in external reporting, regulators might naturally play an important role in ensuring that all companies report this information and that the standards are being enforced.

33. **Should/could common standards apply across industries?**
This is a complicated issue. No doubt some nonfinancial measures, employee turnover for example, could be measured the same way across all industries. In other cases, measuring a certain aspect of performance, customer penetration for instance, will probably require an industry specific standard. Just having standards for nonfinancial measures by industry will be an enormous stride forward; it isn't necessary that standards apply across all industries. If that happens eventually, all the better.

34. **Should there be global standards?**
There certainly should be global standards for all nonfinancial measures within a given industry. Most of the major competitors are multinational companies competing on the global stage. Where a company happens to be headquartered is, after all, only an historical accident. For companies to benchmark their performance against each other and for investors to do the same, global standards within an industry are needed.

Global financial reporting standards across all industries, along the lines of International Accounting Standards, would also be a good thing.