The Australian Financial Review, 25-26 October 2014, page 43

A STRUGGLE TO PLUG VALUE GAP

Investment In a brave new world, dollars and cents no longer do all the measuring work, writes **Agnes King**.

The kinds of heated debates between analysts, investors, companies and their staff that we've seen with the Australian National University's recent black-listing of oil and gas giant Santos will become more frequent, advisers at the nation's largest accounting and audit firms say.

It's because a substantial amount of organisational value is just not reflected in current corporate accounts.

"New and different questions are being asked by new interest groups, which indicates there is more to understand [about a corporation]," PwC global head of audit Richard Sexton told AFR Weekend .

"There is a clear link to value, not necessarily measured in dollars and cents, but that will come."

A confluence of global trends is forcing companies to internalise factors that were once considered external to performance and value – things like environmental, ethical and social behaviour.

At September's United Nations conference in New York, the notion of "1 in 100" got a lot of airtime. It attributes value to "black swan" events, the impact they would have on a country or corporation, and an entity's ability to manage around them.

Willingly or unwillingly, entities are having to attach real value to things like catastrophe management. It has triggered an existential crisis among corporations, Sexton says. "They are sitting back and asking, 'what do we do? And why do we do it?'"

The problem is unlikely to resolve itself until global capital markets settle on a credible reporting regime that captures non-tangible assets and externalities.

Analysis in 2006 by Licensing Executives Society International showed that within the past quarter century, the market value of Standard & Poor's 500 companies has deviated greatly from their book value.

KPMG reporting expert Nick Ridehalgh says there is no doubt "a huge amount of a firm's value is not reflected in their financial accounts".

There are other interesting moves. Earlier this year, Chartered Accountants Australia and New Zealand (formerly the Institute of Chartered Accountants) released a controversial report questioning the continued relevance of gross domestic product as a measure to compare Australia's progress and welfare against other nations.

While GDP captures economic activity, it fails to recognises environmental and social outcomes, as well as things like terrorism, the report stated.

"Interest is growing in communities, governments and internationally as to how a more complete picture of progress can be shown," CAANZ chief executive Lee White says.

Companies have struggled to plug the "value gap" through a plethora of new narrative reports, including investor packs and sustainability reports; the size of annual reports has blown out to almost unmanageable proportions in the past decade.

Internationally, a movement called “integrated reporting” is gaining traction. But without some kind of outside control, integrated reports are still largely perceived as marketing spin. “There’s a great need for credibility and trust in [these] reports,” Auditing and Assurance Standards Board CEO and chairman Merran Kelsall says.

One of the options on the table is a ratings agency which would operate in much the same way as Standard & Poors. In fact, BLab in the United States (see main story) could be an early iteration. Another option involves an evolution of current financial audits. This is one of the reasons big-four accounting firms are so interested in the area. There’s a good chance it will evolve into a new income stream for them.

While credibility is desperately needed, one thing experts feel isn’t needed is regulation. Forcing companies to report on these criteria while the movement is so immature could, they fear, stifle innovation and best practice. Ridehalgh says: “More regulation is not required in Australia; [the movement] is happening through Australian Securities Exchange corporate governance principles and governance by Australian Securities and Investment Commission around operating and financial reviews for listed entities.”

Fresh changes to ASX corporate governance principles have upped the ante in relation to “total impact” reporting. From July 1, 2014, boards are now responsible for the integrity and controls over all forms of corporate reporting by an organisation, not just the financial report.

This might seem like a small thing, but it’s not. New ASX guidelines also require directors to give more clarity around social, environmental and governance risk, across the short, medium and long term. All this talk about forward-looking statements is making company directors extremely anxious.

Benchmarking against new forms of capital to satisfy stakeholders is all well and good in theory, but it exposes directors to many more risks.

Through vehicles like the Australian Institute of Company Directors, they are calling for legislative change so investors can’t sue them if reasonable forward-looking statements about medium- or long-term prospects don’t come to pass.

Interest is growing . . . as to how a more complete picture of progress can be shown.

Lee White, CAANZ