

Can a different framework of value enable greater trust in business?

Defining the journey towards more effective
measurement and reporting of value



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EY

Building a better
working world



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Foreword

The world is changing at a rapid rate; business is fast becoming enabled with new technology which will mean faster and lower-cost delivery of quality services.

This has led to a world of hyper-connectivity in which machine learning is already able to diagnose certain diseases more accurately than doctors, autonomous vehicles are entering the market and business transactions are verified through the use of blockchain technology.

But business is not only facing new technological enablers. Recently, we have seen radical shifts throughout politics and society. These shifts can be managed for positive outcomes but could also be damaging to business.

Whilst all this is playing out, it is clear that we will need to invent new regulatory and ethical regimes. Current governance methods are already outdated and are not providing the assurance needed by business and society.

One of the key changes that we have detected is that intangible drivers make up a much larger percentage of organisational value. The current accounting standards do not support this trend.

It is against this backdrop that EY and Cambridge University have undertaken an extensive study on what accounting and reporting could look like in the 21st Century. We were not surprised to find that investors and other stakeholders find little value in the way that companies report today.

In our discussions with business leaders, academics, employees and investors, we not only got a real sense of the scale of the challenge, but also of the intense urgency to take action now.

We hosted a number of business leaders for a roundtable discussion on 31st October 2016. We expected interest in the topic, but nothing could have prepared us for the overwhelming response that action is required on this issue.

This paper and our accompanying white paper are the precursor to a series of pilots in 2017. We want to emphasise that this is a call to action as well as a potential way forward and we are delighted that so many investors, think-tanks and business leaders are actively engaging on this. In our capacity as a professional services organisation we are going to step up and catalyse the market to collaborate in tackling this challenge.

Our findings show that a new way forward will need to pass six tests – summarised as:

1. The new way of reporting should be clear about context
2. It must be material to stakeholders
3. It is critical that the organisation describes its purpose in a meaningful process
4. To be trusted it must be assured
5. It should provide a more complete view of value, and
6. It must to simple to understand.



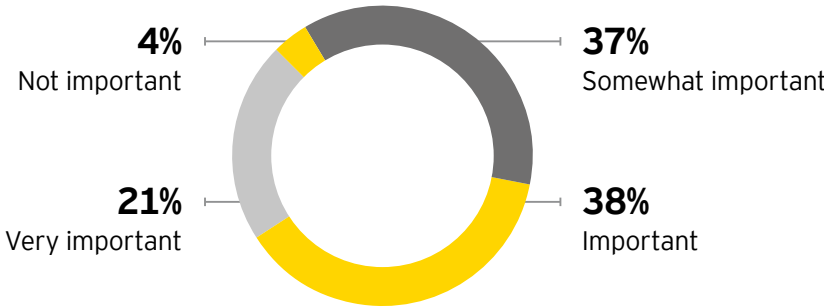
Hywel Ball
Managing Partner
Assurance, UK&I



Herman Heyns
Partner Lead for Data
Analytics & Assurance
Technology, UK&I



When asked how important the annual financial report is to investors, only 59% of finance professionals said that it was 'important' or 'very important'.



Source: EY long term value survey 2016

Understanding the challenge

The world has changed since the turn of the millennium. This is evidenced by the rising importance of the intangible aspects of an organisation's business model; technological revolutions enabled by the internet (the emerging internet of things and associated prevalence of big data); issues of governance and trust, equity and fairness in society; increasing income differentials and consolidation of wealth; social unrest and political upheaval.

We now live in a world of hyper-connectivity, data ubiquity and brand affinity, which has resulted in two important changes for organisations. First, their business models have been transformed. Intangible assets increasingly represent the impetus behind the generation of value for 21st century organisations. Secondly, it has dramatically increased the awareness and influence of a wider range of stakeholders, ultimately challenging the traditional view of shareholder primacy. Reporting is struggling to keep pace with the changing shape of business and seems unable to cater for the rise in the importance of a wider stakeholder group. The current language of value is becoming increasingly inadequate and it is important to understand how this contributes to the ongoing discussions and debates about organisations and stakeholders. In particular:

- The data explosion has created a significant shift in data flows, and now visibility of an organisation's activities has greatly increased. Organisations can try to control the flow, but evidence shows that this has proven fruitless and counterproductive.

If corporate reporting makes up such a small percentage of the relevant information available, how can it remain relevant?

- Data credibility is becoming a serious issue. Reviews and comments are likely to be made by those who have stronger opinions, creating biased views of organisations. Also, prioritisation algorithms tailor our internet experience to show us what we want to see, which in turn means we are less inclined to challenge the reliability of information.

How can the focus on unverified data shift back towards corporate reporting unless it begins to provide information that is more relevant and trusted?

- While the theme of short termism has been around for years there is an enduring perception from both executives and investors that the other party is short termist in their thinking. This is characterised by increased dividend distributions and share buybacks, and a continuing decrease in long term investment, such as research and development spend. This focus on value extraction is stunting innovation, organisational growth, and ultimately global economic growth.

Without a language that can articulate how an organisation is reinvesting its cash flows to generate long term value, how can investors focus beyond short term returns?

- Questions about the role of organisations in society – do they exist to create value for shareholders or do they have a broader purpose, creating value for a wider group of stakeholders? Recent events such as the global financial crisis highlight how organisations within society are interconnected.

In future, can organisations really retain their 'licence to operate' if they do not report to a wider range of stakeholders?

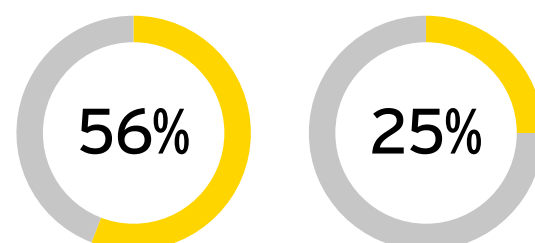
Cumulatively these problems signal a deeper and more systemic issue – the perceived lack of trust in organisations and those who lead them. It is important to recognise that the inadequacy of reporting is a significant contributor to this breakdown in trust and that action must be taken.

Current approaches

The current landscape is fragmented and creating confusion in the boardroom and beyond.

Long term investment

Whilst 56% of the business leaders that we spoke to think that financial reporting clearly conveys how a company can create future value through reinvestment, only 25% of investors think this is true.



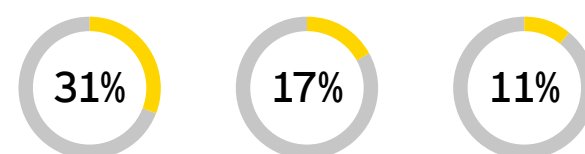
Business leaders

Investors

Source: EY long term value survey 2016

Investor relevance

Only 11% of business leaders and 17% of investors believe that current financial reporting meets the needs of investors, whilst 31% of finance professionals believe it does.



Finance professionals

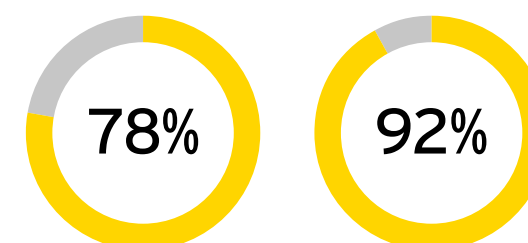
Investors

Business leaders

Source: EY long term value survey 2016

Need for change

78% of the business leaders that we spoke to and 92% of the investors told us that they think that the accounting profession, investors and companies should collaborate to overhaul financial reporting.



Business leaders

Investors

Source: EY long term value survey 2016

While there have been numerous approaches to resolve the challenges, there is currently no comprehensive solution that meets the requirements we have identified in our market testing phase. Current attempts have sought to solve the problem through three broad approaches:

- **Additional reporting:** Attempts such as Integrated Reporting and Sustainability Reporting have sought to answer the problem by creating new reporting frameworks. These initiatives have made a positive contribution but have not achieved widespread investor acceptance.

► **Creation of metrics/key performance indicators (KPIs):**

New metrics and KPIs such as the Dow Jones Sustainability Indices have enabled organisations to communicate useful information to their stakeholders. In addition, they allow for organisations to be assessed on a wider range of measurements. However, this does not fill the fundamental gap in information flow about how organisations create long term value.

- **Discussion and collaboration:** Bringing together organisations and asset managers through initiatives such as the Coalition for Inclusive Capitalism and Focusing Capital on the Long Term has raised awareness of the problem statement and the need for organisations to report to a wider range of stakeholders. This has created an excellent platform for a solution and has raised the urgent need for one.

Progress in improving trusted information flow has been slow. In contrast, the global business landscape and the way in which organisations generate value is evolving faster than ever. To keep pace, a more comprehensive solution that benefits the organisation and its stakeholders is needed.



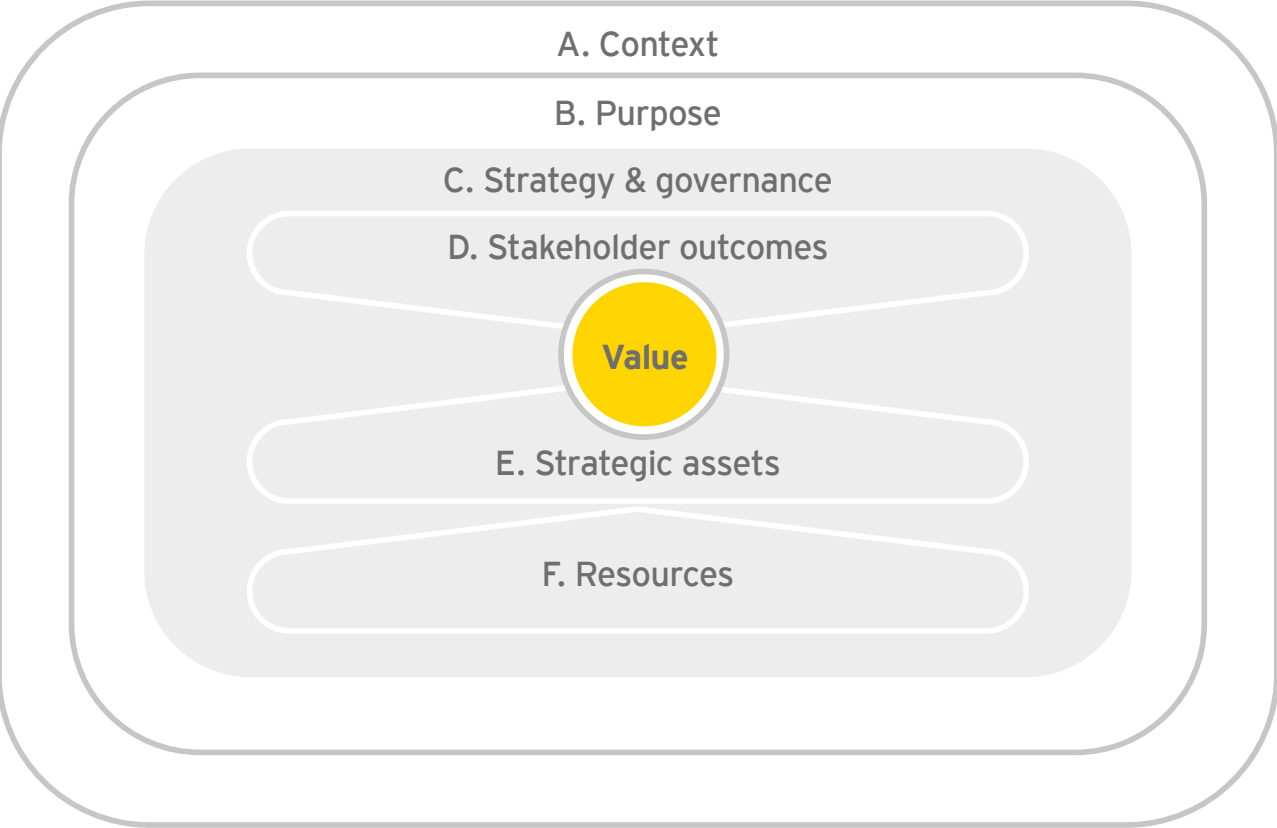
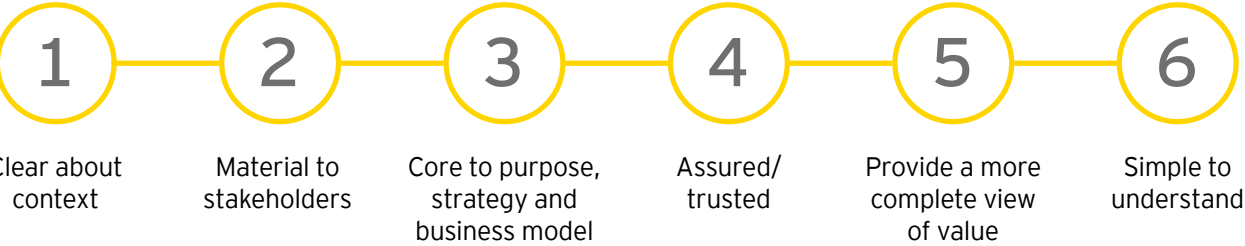
Attributes for a new framework

Building on our discussions with academics, investors and business leaders, we have identified six criteria that must be fulfilled in order to achieve effective long term value reporting.

In summary, such reporting should be:



Defining the model



A. Context

Context within the frameworks means context within which the organisation operates.

As well as the operating context it encompasses:

- macroeconomic
- societal
- environmental
- legal
- technological
- political
- market trends

Specifically the business models employed by the firm and its competitors.

B. Purpose

Purpose is an aspirational reason for being, grounded in humanity and inspiring a call to action.

The purpose of the company can be attributed to certain characteristics as defined by the Big Innovation Centre's six categories of purpose: Universalisation, Innovation, Excellence, Fresh challenge, Global responsibility and Human values.

C. Strategy and governance

Identifying the strategic assets required to deliver the organisation's strategy, and ultimately, the stakeholder outcomes is key to the long term value framework. By understanding and communicating what strategic assets exist within the organisation, we can get a clear understanding of what strategic assets need to be developed, what existing assets need to be protected and, therefore, where capital should be allocated in order to deliver the organisation's strategy.

D. Stakeholder outcomes

Stakeholder outcomes are the fundamental dimensions of performance that matter to different stakeholders. By delivering against these outcomes, the organisation is creating value for stakeholders.

E. Strategic assets

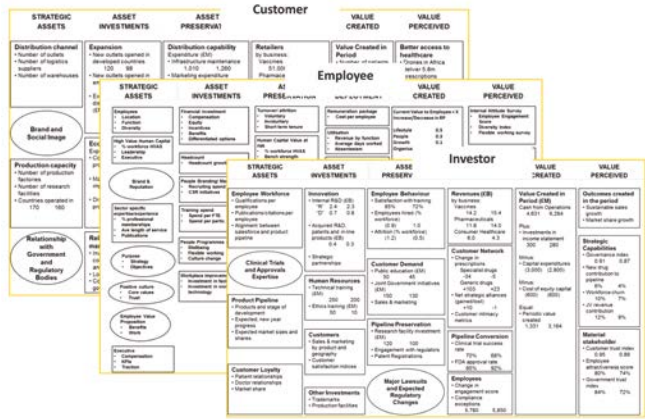
Strategic assets are bundles of resources and skills that organisations can deploy to create long term value for stakeholders and could include anything from an organisation's culture to the physical assets it owns. They are created through the procurement of a broad range of resources and are: 1) valuable, 2) rare and 3) difficult to imitate.

F. Resources

Resources can be defined by the six capitals. They are the basic resource building blocks that organisations can invest in to develop strategic capabilities that are valuable, rare, inimitable and non-substitutable (VRIN).

Stakeholder Reporting

By implementing the long term value framework, organisations can articulate how they are allocating their capital in order to deliver value for their stakeholders.

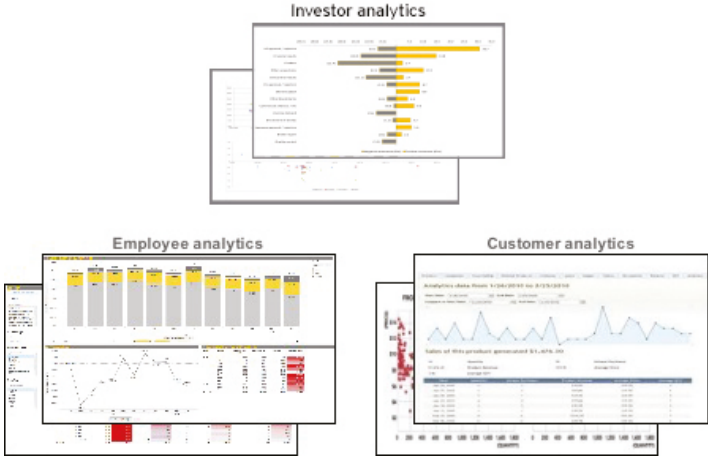


Enablement through data and analytics

The amount of data and the tools available to analyse this data is increasing exponentially.

This enables:

1. More comprehensive accounting for the six capitals
2. Identification of strategic assets, and
3. Measurement of stakeholder outcomes.

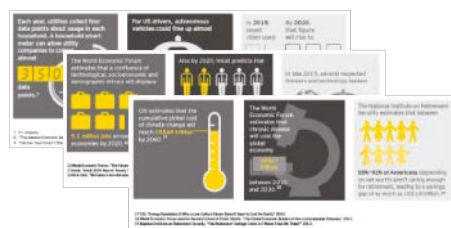


How we can help organisations

The following are some of the services we provide to develop long term value:



Context



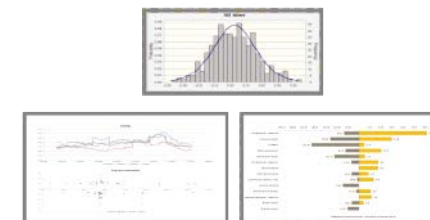
We help organisations seize the upside of disruption by helping them to challenge entrenched thinking, shift perceptions and help catalyse change.

Purpose



Our Beacon Institute engages leaders and board influencers in a different kind of conversation. By unlocking insights and better questions around longer term, more strategic concerns, its ambition is to guide organisations in their pursuit of purpose.

Stakeholder outcomes – Investors



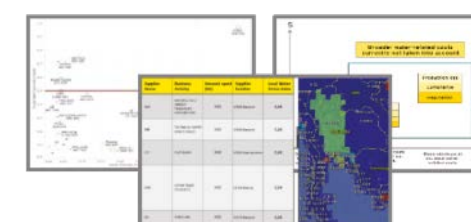
By analysing global news feeds and share price movements we provide organisations with insights into investor perceptions of their organisation and competitors.

Stakeholder outcomes – Employees



We provide organisations with cultural integrity assessments to identify the alignment or misalignment of cultural values that support or inhibit organisations realising their strategic objectives and goals.

Resources – Natural capital



We help organisations to identify and analyse the risks, costs and benefits associated with natural resources so that they can make more investment decisions.

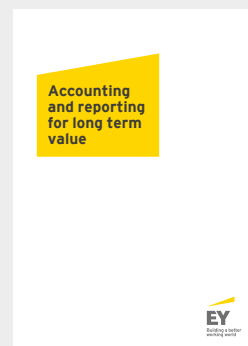
Contacts



Hywel Ball
Managing Partner Assurance, UK&I
Tel: + 44 (0) 207 951 2474
Email: hball@uk.ey.com



Herman Heyns
Partner Lead for Data Analytics & Assurance Technology, UK&I
Tel: + 44 (0) 207 951 6051
Email: hheyns@uk.ey.com



Please go to [ey.com/longtermvalue](https://www.ey.com/longtermvalue) for our white paper, 'Accounting and reporting for long term value'.

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