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Management Update
A NEWSLETTER FROM HARVARD BUSINESS SCHOOL PUBLISHING

ARTICLE REPRINT NO. U0205E

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by Joseph Fuller

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The Accounting Transparency Gap

Clarifying the relationship between share price and operating performance isn't simply about reassuring investors and regulators—middle managers stand to benefit also.

by Joseph Fuller

ACCOUNTING stories rarely make the front pages of the newspaper—particularly when they cover such arcane topics as off–balance sheet financing and accounting for derivatives. The Enron debacle has hammered home to the wider public a point that only those few who follow accounting matters on a regular basis have been aware of up to now—that accounting practices have failed to keep pace with the complexity of business.

Supranational organizations working in a vast global marketplace have far outstripped the tools that accountants and bankers have to value them, that regulators have to regulate them, and that investors need to evaluate them. Enron's swift demise serves as a wake-up call for many managers, who now see the need for greater transparency in how companies report their earnings and describe their operations.

It has long been a business axiom that if you don't measure it, you can't manage it. The corollary is also true: if you don't report it, you can't be held accountable for it. This holds whether you are a CEO responsible to the board and shareholders for the performance of the entire company, or a line manager responsible for the performance of a small unit.

The trouble is, many companies report their performance in such an opaque way that shareholders and regulators aren't the only ones in the dark—many middle managers are also left with only the vaguest understanding of how their company creates value. Greater transparency, in other words, won't just make life easier for people outside the firm looking in—it will make the work of a company's managers easier, too.

By creating a common language for discussing performance inside and outside the firm, the improved transparency will give managers a clearer understanding of how their individual actions can affect companywide performance. And that better understanding, in turn, will translate into a greater sense of responsibility, a higher level of motivation, and better-calibrated decisions that are more likely to effect change where it will matter most.

Old rules straining to encompass current realities

The financial and managerial accounting systems that managers use today to define their businesses, demonstrate their prospects, and measure progress were designed in another time for business of a different kind. Their origins lie in the double-entry bookkeeping system created 500 years ago by the Italian monk Luca Pacioli, but they were first developed in earnest during the 1800s by the textile companies and railroads.

In the 1920s, Du Pont and General Motors adapted these systems for large-scale, multidivisional organizations. In sharp contrast to the competitive reality today, GM existed in a slow-moving market back then. It owned a large percentage of its suppliers and made something you could touch and count—products that had one stable price point and that were sold in one market using one currency.

Little wonder then, that the Generally Accepted Accounting Principles (GAAP)—the operating manual for the accounting industry—are ill-equipped to deal with the realities of information-age companies. GAAP's inadequacy has been clear for years. Writing well over a decade ago, Warren Buffett, the widely admired investor and CEO of Berkshire Hathaway, had this to say about GAAP: "The business world is simply too complex for a single set of rules to effectively describe economic reality for all enterprises, particularly those operating in a wide variety of businesses." Now, Enron's bankruptcy has brought the need to do something center stage.

Making matters worse, the numbers that are generated for financial reporting are often much different from those actually used to run the company; as a result, a divorce occurs between shareholder value and the day-to-day work of the vast majority of managers in a company.

Despite the proliferation of stock-option programs and other devices used to focus management's attention on improving share price, in my experience most managers in most companies remain essentially insulated from the entire subject of value creation. Even in companies with a long-standing commitment to the principles of shareholder value, most of the approaches employed to date either fail to instill the appropriate discipline in line managers or fail to install the organizational checks and balances required to enforce the adoption of value-maximizing strategies.

The line management of most companies simply doesn't understand the nature of the relationship between share price and operating performance. The two have, over time, come to be seen as almost unrelated by many executives. Capital markets seem to demand a sustained level of performance and expect markets to behave in orderly ways, yielding predictable, linear results. But no market actually looks like that over an extended period.

Most managers below the executive suite find it hard to reconcile that disconnect between what Wall Street

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expects and what they believe is achievable. They understand that share price and operating performance are related, but they struggle to understand the numbers that headquarters stipulates—numbers that often have their origins with Wall Street analysts' projections. Such projections, and their importance in driving value creation, become the province of the CEO, CFO, and the chief investor relations officer. Associated with this excessive focus on Wall Street's expectations has been a failure by managers across the board to deepen their understanding of shareholder value drivers. In addition, middle managers have become skeptical about senior management's apparent preoccupation with meeting forecasts.

Augmenting, instead of replacing, GAAP

Envisioning a substitute for GAAP, however, is fraught with difficulty. It brings to mind the famous remark from Winston Churchill: "No one pretends that democracy is perfect or all-wise. Indeed, it has been said that democracy is the worst form of government except all those other forms of government that have been tried from time to time." Buffett echoes that view when he writes that he would hate to have the job of devising a better set of rules.

So how should we proceed? Perhaps CEOs should "treat GAAP statements as a beginning rather than an end to their obligation to inform owners and creditors," Buffett continues. "What needs to be reported is data—whether GAAP, non-GAAP, or extra-GAAP—that helps financially literate readers answer three key questions: (1) Approximately how much is this company worth? (2) What is the likelihood that it can meet its future obligations? and (3) How good a job are its managers doing, given the hand they have been dealt? In most cases, answers to one or more of these questions are somewhere between difficult and impossible to glean from the minimum GAAP presentation."

Buffett, for his part, reports not only consolidated information required by GAAP but segment data. A few other companies have begun to follow suit. Last year, Barry Diller, head of USA Networks, a conglomerate whose businesses include the Home Shopping Network, USA Cable, and Ticketmaster, decided to provide analysts with internal budgets broken down by business segments.

It's unlikely that most companies will ever succeed in reaching the clarity that Mr. Buffett provides his shareholders. But at the very least, companies should state their strategies clearly, identify associated value drivers, and report auditable metrics on both. That way, both shareholders and management have a relevant way to judge progress against the company's stated goals.

How much is this company worth? Buffett asks. How likely is it to meet its future obligations? And how good a job are its managers doing, given the hand they have been dealt? Companies need to report data—whether it's GAAP, non-GAAP, or extra-GAAP data—that helps financially literate readers answer these three key questions.

Metrics with meaning

A company that pursues a carefully mapped out strategy with a clearly articulated set of performance metrics will be in a better position to give middle managers a clear understanding of how their actions will affect the performance of the firm as a whole. This applies to the head of manufacturing who tracks performance across an entire network of plants as well as to a paint shop supervisor who needs to clearly understand how local performance contributes to overhead, customer satisfaction, and, ultimately, share price.

At the operating level, performance should be evaluated on the basis of financial variables most closely tied to the operating-value drivers controlled by individual managers. In other words, metrics need to be developed to reflect the specific decision rights afforded individual managers. After all, what's the point of evaluating a supply chain manager on the basis of inventory levels when his controllable value drivers are factory orders and shipments to distribution centers? At each level in the organization, all relevant value drivers should be tracked and, in most instances, a single, value-focused metric chosen to evaluate the results of decisions made at that level.

Interestingly, many of these metrics and drivers could and should be reported to shareholders, since they are likely to be the ones that either directly correlate to shareholder value or are key components in the strategy. Some executives may complain that making this all clear to the analysts will reveal valuable information to their competitors. To this, there is a simple response: if your strategy is based on your competitor not knowing what you are doing, as opposed to not being able to do what you can do, you won't succeed in the long run.

The Enron case marks the end of an era in which analysts had power, unsophisticated investors made decisions on little more than faith, and management's incentives were geared toward getting the highest possible price for their shares in the fastest possible time. Of all the lessons of the Enron case, the one that stands out most is the need for transparency and clarity in the actions of both individuals and the enterprises that employ them. ❖

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