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NON- FINANCIAL REPORTING: CORPORATE SOCIAL RESPONSIBILITY, EXECUTIVES AND MATERIALITY

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ABSTRACT

This paper reviews some of the important papers on Non-Financial Reporting and tries to explain how Non-Financial Reporting is becoming part of usual reporting. In first part of this review, we have gone through some important research papers which relate Non-Financial Reporting with the executive compensation. The second part of this paper has reviewed the research articles emphasising on the materiality of non-financial information as it is for financial information. In the papers reviewed it is found that due to emergence of the concept of corporate responsibility the use of non-financial information has increased and due to this the reporting of non-financial information has also increased. Materiality of non-financial information could not be defined by any of the paper as quantitative rule can't be applied to such information as in the case of financial information.

KEYWORDS

non-financial reporting, non-financial information and non-financial accounting.

1. INTRODUCTION

This review article examines the increasing role of non-financial information as compared to financial information. The role and functions of financial accounting rest upon financial information which is not sufficient for various stakeholders in the present scenario. Basic assumption of financial accounting is that users are those who have financial stake in the entity reporting, stakeholders like shareholders who have invested in the company other stakeholders like government (for taxes and subsidies) and financial institutions who have extended loans to these company and have to check performance of these company in order to be sure that their funds are safeguarded and are performing assets. As the firms and environment in which firms function is becoming complex, financial information alone is just sufficient for the immediate stakeholders alone, in light of paradigm shift it is necessary to report to the society at large. This concept arises out of *Murty (2007)* which has laid down the fundamental basis of business ethics and corporate responsibility. It is argued that business ethics and corporate responsibility are two sides of same coin Murty (2007) has shown that corporate responsibility consist of 1) environmental accounting, 2) corporate governance, 3) corporate social responsibility. **(Murthy, 2007)**

Considering non-financial disclosures are voluntary in nature, Non-financial reporting is not regulated as compared to financial disclosures; firms have significant latitude in choosing whether to disclose, and if to disclose, what, where, when, and how to do so. Furthermore, the volume of discretionary information releases is considerably greater than that of mandatory filings.

Complexity of financial information and overload of information coupled with difficulty in understanding of financial reports has opened avenues for non financial disclosures. Earlier, non financial disclosures were considered as to be quantitatively immaterial but as stakeholders are considering it to be as important as financial information there disclosures are increasing.

Set of stakeholders is becoming wide. Different stakeholders are interested in different information, which cannot be fulfilled with just financial disclosures. Financial reporting metrics leads to a short-term orientation and short-run operating decisions that boost short-term profit at the expense of long term performance.

The financial information explains just the historical performance, while the stakeholders try to predict the firm's performance in future. Thus, there is a great need for information which can facilitate predicting future performance and this need can be efficiently filled by non-financial disclosures. This shift in information preferences has stimulated a substantial increase in the volume of non-financial information conveyed by firms to their stakeholders and market participants.

To satisfy broader set of stakeholders disclosure of non-financial information is gaining pace. Therefore, we can observe shift in corporate reporting paradigm towards reporting of non- financial measures and hence it points out the need for reviwing and examining the literature on non-financial reporting.

In the next section, there is a review of the relevant research. This is divided in different sectons namely firm, stakeholders, executives, corporate responsibility and materiality. It is followed by a table, summarising the different papers reviewed. Next, there is a critical analysis of the papers reviewed, which is followed by conclusion.

2. REVIEW OF LITERATURE

In this section, various studies that have examined the non-financial reporting in relation to various dimensions of corporate social responsibility are reviewed.

2.1 NON FINANCIAL REPORTING AND "THE CORPORATE RESPONSIBILITY"

This area focuses on the shift in the philosophy of business.

Murthy in 2007 gave a new perspective of thinking for business ethics and social responsibility. The term corporate responsibility has been properly elaborated. This study talks about the paradigm shift in the philoophy of business. The idea in the paper is as follows, this paradigm shift in philosophy has broken down the compartmentalization of business and society. Shift in the philosophy of business points out that businesses are giving more attention towards social and environmental issues. The role of state has been on decline from the social space have created a vacuum and the needs of the society have not declined so, businesses have to emerge as a filler. This has imposed a responsibility of businesses toward society.

This study also talked about triple bottom line reporting (including three dimensions of corporate responsibility) which is an integrated approach to public reporting of environmental, social and economic outcomes. Further, it discussed that a series of internal and external pressures influence the corporate leaders to address ethics such as increasing influence of Non-Government Organizations (NGOs), role of media.

The study explained that another reason for shift in the philosophy of business is organisational transformation. Organizational transformation is particularly pertinent to changing the different features of the organization such as structures, processes, information system, human resource practices and work design. Changes in these features of the organisation would change the philosophy of business.

It suggested that top management must bring about organizational transformation so as to make the approach trifocal approach, namely environmental accounting, governance, corporate social responsibility, sustainable and that a business has to be responsible towards society, accountable to the environment and good to its shareholders. It concluded that without having such ethical conduct, ia business may cease to exist. **(Murthy, 2007)**

2.2 NON-FINANCIAL REPORTING AND "THE EXECUTIVES"

This part focuses on the non financial disclosures and its effect on executives and how non financial measures can be used as coordinating devices in the organisation.

In a study by Ibrahim and Lloyd in 2011, the relationship between executive cash bonus compensation that is based on non-financial performance measures (NFPMs) and earnings management (EM) is examined,

They explained that executive compensation in firms typically consists of a base salary and an incentive-plan that could be short-term in nature (cash payment or bonus) and/or long-term (stock options, restricted stock holdings or stock-appreciation rights) and that the short-term compensation in the form of a cash bonus

is typically contingent on executives meeting specific levels of pre-established performance measures, in which case it would be considered performance-based compensation.
To test this, they took a sample of 329 firms in S&P500 as on 31 December 2004. They developed a model using multiple regression and used Z-test to test the hypothesis.
They found out that the firms which use NFPM have lower discretionary accruals than their counterpart firms that employ only FPMs.
The findings can be interpreted as indication of lower incentives for EM behaviour in firms in which executive bonus compensation is contingent on achieving levels of NFPMS, since the executives' pay is based on variables that focus on the long-term. EM behaviour in firms can be curtailed by using a mix of FPMs and NFPMs in compensating top management. **(Ibrahim and Lloyd, 2011)**
In another study by Baiman and Baldenius in 2009, the role of non-financial performance measures in mitigating inefficiencies that arises as a result of inter-divisional externalities was analyzed.
They developed a contracting model to analyse how a system of divisional financial performance can be related with non financial performance measures so, as to mitigate interdivisional externalities. In this model, they used non-financial performance measures and bonus as an instrument that facilitates information sharing between privately informed agents.
This model gave empirical predictions about the incentives weight associated with non-financial performance measure as a function of observable variables. The model results explained that higher the bonuses, the closer were the agents bid to their true valuation and hence more information was used in the implementation of decisions. **(Baiman and Baldenius, 2009)**
A study by Surysekar in 2003 studied the effect of the interactions between two non-financial measures of performance in an agent's incentive compensation scheme, namely meeting output targets and getting output that needs no rework. The principal trades off - (1) a penalty for not meeting output targets, and (2) cost of reworking output that is defective when initially produced.
Overall, their analysis established that, from an incentive compatibility point of view, the agent may actually decrease effort at obtaining first pass yield (not needing rework) in response to greater incentives for providing such an effort. The reason was that the principal was trading off the cost of reworking defects against the penalty of not meeting output targets. Further, it explained that as rework costs increased, the cost-minimizing principal provided greater incentives for producing first pass yield (not needing rework), and reduced the weight on total output in the agent's incentive compensation. The agent responded to by steeply reducing overall effort provided, and this was more than sufficient to offset a positive impact of a greater weight on first pass yield. **(Surysekar, 2003)**

2.3 NON-FINANCIAL REPORTING AND MATERIALITY

This part focuses on the concept of materiality for non financial measures. Materiality would be one of the material issue for different non financial measures.
In a study by Mio and Fasan in 2013, the materiality issue for financial and more specifically for non-financials was examined. This article used a futuristic approach. Materiality, both in financial and non-financial reporting will be one of the central issues to tackle in order to make accounting better. In this article, they provided an "evolutionary" discussion of definitions and frameworks and they have pointed out which are the main future challenges companies and standard setters will have to face.
They also provided an empirical analysis about the main differences between companies tackling the issue of materiality more effectively compared to the whole population of the IIRC Pilot Program firms. They have selected 5 companies out of 83 companies in total from IIRC Pilot Program.
They found that the governance system plays a role in determining how companies deal with materiality. **(Mio and Fasan, 2013)**

3. CRITICAL ANALYSIS

Studies taken in the literature review are trying to cover every aspect of non-financial reporting right from factors of firm affecting the reporting to its uses and problems.
Non-financial information is considered as residual category including all the information which cannot be expressed in monetary terms. **(Mio and Fasan, 2013)** This definition is focusing on the importance given to non-financial information and the criteria whether to include it in non-financial or not. But there should be further classification to know which non-financial information is useful and which is not material. The conflict starts here because to know the materiality of non-financial information, the users of such information have to be kept in mind as some information which is useful to certain group of users may not be useful to others or some non-financial may not be useful to anyone. For this classification, the concept of materiality threshold cannot be applied as done for financial information as non-financial are not classified in monetary terms. Materiality definitions in the context of financial and non-financial information differ substantively, but at the broader level of analysis it is possible to find a similarity between the definitions of materiality in the two contexts: they both refer to the decision usefulness of the information for the intended user of the report. So, the only way to find the materiality is to know the usefulness of the information for various stakeholders.
A world where the market value of the firm is decoupled from the value of its underlying assets, non-financial information offers a tool for measuring the firm value arising from intangibles and future cash flows that is missing from traditional financial reports. An interesting study by Ocean Tomo in 2011, provided evidence confirming that financial information is not enough for investors and stakeholders to have a complete understanding of companies' performance and value. According to the findings of the study, physical and financial assets reflected on a company's balance sheet comprise only approximately 20% of the true value of the firm. Therefore, roughly 80% of the market capitalization of the S&P 500 companies is determined by intangible assets, that require both financial and, most importantly, non-financial information in order to be properly evaluated by investors and stakeholders. This shift in information preferences has stimulated a substantial increase in the volume of non-financial information conveyed by firms to their stakeholders and market participants. This increase in disclosure of non-financial information is also because of increase in the pressure from internal and external stakeholders. As the stakeholders are now not just confined to the users who have financial stake but include a wide array of users who may not have financial stake but monitoring regularly the working of firms. Stakeholders like media, government, Non profit organisations(NGOs) are equally concerned with the performance of firms as stakeholder who have financial interest like shareholders, employees etc. So, owing to this increased role of non-immediate external stakeholders businesses have to disclose more information regarding other activities and attitude towards environment and society. This has led to shift in the philosophy of business. **(Murthy, 2007).**

4. CONCLUSION

The purpose of both financial and non-financial disclosures is to give useful information to the users. But an overemphasis on financial reporting metrics leads to a short-term orientation and short-run operating decisions that boost short-term profit at the expense of long term performance.
Financial reports are becoming increasingly complex (thus investors have difficulties in understanding the economic substance of transactions) and backward oriented (thus, for the most part, they provide information about the past, while investors need to understand how companies' performance will evolve in the future).
Given these limitations of historical financial information, an important question arises about what other information is of benefit to potential stakeholders. This gap can be filled by non financial disclosures. The value-relevance of non-financial information has increased over the last several years. Most top executives at large multinational firms believe that non-financial performance measures are more valuable than traditional financial measures in assessing long-term value **(PricewaterhouseCoopers, 2002).**
Accounting information is now been substituted or complemented by non-financials for various purposes such as incentive compensation, prediction of costs and profits, valuation of firm, detection of fraud etc. Financial information becomes more valuable if it is supported by non financials.
Non-Financial disclosures help stakeholders to validate and predict the performance of the firms as non financials are more futuristic in approach. It helps various stakeholders specifically investor to justify their investment as strong non financial information helps to support the sustained performance of the firm.

One of the major concerns for non-financial reporting is of materiality as all financial and non-financial information is not material but for financial information some quantitative criteria can be set up but the same is not possible with non financials. So, some non-financial information may be left out because it is considered as non material by the reporting firm. But it may be material to certain group of stakeholders.
With this increasing role of non-financial disclosures it is necessary to have some concrete standards for the measurement and disclosure of non financials. If there are principles governing non-financial as there are for financials then non-financial information would be more reliable and comparable.

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