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A FIRM'S PERSPECTIVE OF NON-FINANCIAL REPORTING

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ABSTRACT

This paper reviews some of the important papers on Non-Financial Reporting and tries to explain why 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 to the importance of non-financial reporting. The second part of this paper we have given some relevant theories which explains why non-financial reporting is becoming as important as financial reporting. It is seen that in order to satisfy all the stakeholders, reporting of non-financial information is necessary. Such information has become more valuable over the years as the concept of corporate responsibility has been accepted by all the stakeholders.

KEYWORDS

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

1. INTRODUCTION

The value-relevance of non-financial information has increased markedly 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). This shift in information preferences has stimulated a substantial increase in the volume of non-financial information conveyed by firms to their stakeholders and other market participants.

Thus, current mandated financial reporting does not give a complete picture of a firm and is too short-term in orientation (Holder-Webb et al. 2008, 2009; Simnett et al. 2009a). In 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 (Lev 2001).

Given the limitations of historical financial information, an important question arises about what other information is of benefit to potential stakeholders. In a study, Cohen et al. (2011) found that retail investors were most concerned with non-financial disclosures that more directly affected future earnings such as the disclosure of leading economic indicators. In a recent review of developments on the integration of financial and non-financial information, Adams et al. (2011) argue that, "Integrated reporting is a means to providing a more coherent, balanced and complete picture of company performance, centred around strategic objectives and business models, and sensitive to the multiple drivers of value for today's businesses."

We can classify non-financial disclosures into two compartments namely economic and non-economic indicators. Economic indicators here mean the metrics which directly relates to performance of the business like market share, quality rankings, customer satisfaction, employee satisfaction, turnover and innovation etc. While, non-economic indicators are those metrics, which are not directly related to the business of the reporting entity like expenditure on environment, CSR undertaken expense on employees' betterment etc. Firms are keeping their stakeholders informed about both the indicators. But with the growth in demand of responsibly produced and fairly traded goods the focus has been shifted towards non-economic indicators.

Corporate social responsibility (CSR) activity is an area of intense and increasing interest both on the practice and academic fronts. Assets under professional management and invested with a social responsibility focus have also grown dramatically over the last ten years. Investors choosing social responsibility investment strategies require access to information which is not just provided through traditional financial statements and analyses. At the same time, a group of mainstream institutional investors has encouraged a movement to incorporate environmental, social, and governance information into equity analysis, and multi-stakeholder groups have supported enhanced business reporting on these issues.

Investors are not the only interested parties; CSR activity provides an increasing focus of product development and marketing practitioners. Research demonstrates that certain types of CSR activity produce value for firms in terms of brand loyalty and marketing advantages (Brown and Dacin 1997; Sen and Bhattacharya 2001). As Handleman and Arnold (1999, p. 36) note, "In any community, it is common to find retailers donating to local charities, sponsoring little league sports teams, and proudly displaying the national flag. These actions demonstrate the retailer's adherence to unwritten but powerful normative rules of acceptable social conduct, such as becoming involved with the community and promoting national pride."

According to the SIF, "issues now occupying mainstream consciousness – corporate governance, transparency, accountability, and greater disclosure – have long been central to the practice of social investing." In this study, we tried to found out the effects of certain type of social and environmental expenditures on the market capitalisation of top 200 firms listed on national stock exchange during the period of 2011-12 and 2012-13.

The next section presents literature review. In section 3, we review some relevant theories and some earlier studies to present a conceptual framework and answer the 'Why' of non-financial reporting. In the following section, we conclude our review of theories.

2. LITERATURE REVIEW

The historical emphasis of traditional financial information does not answer the needs of stakeholders, who require information not only about future earnings but also about the firm's social and environmental responsibility and interactions with the environment and home communities (Adams 2004; Anderson et al. 2005).

The historical focus of financial reporting provides an incomplete picture of a firm's current status to auditors, investors, and creditors and has limited relevance for evaluating future prospects (Lev and Zarowin 1999; Lev 2001; Graham et al. 2005). Cohen et al. (2000) demonstrate that the efficiency and effectiveness of audits is improved through auditor use of non-financial information. However, the backward-looking financials are subjected to assurance services, are standardized among firms by GAAP, and possesses the currency of long use by external parties; thus stakeholders may over-rely on financial information that does not fully reflect the sources of value of a business. These issues with the historical and financial approach to disclosure are well known to the regulatory and investing community. Disclosure of non-financial information is essential to reduce the information asymmetry that exists between management and important stakeholders (Narayanan et al.2000). Providing non-financial information allows investors to better assess key areas of performance and supports a broader view of corporate performance that also encompasses society at large (Holder-Webb et al. 2009). These insights are not new – the role of intangibles such as quality of management in corporate success has a long history in the literature (Trueman 1986) – but they do point to a crucial question raised by critics of the current reporting system. What is the most effective way of informing stakeholders of those elements of business performance that do not show up on the financial statements?

A number of recent initiatives designed to encourage the integration of financial and non-financial metrics in an integrated reporting framework have arisen over the past decade. For example, the Global Reporting Initiative (GRI) (2011) provides guidelines for presenting a sustainability report that emphasizes evaluating a company by its ability to promote sustainable growth that is also cognizant of environmental, social, and governance metrics. Adams et al. (2011) argue that three major differences between integrated reporting and traditional reporting are "incorporating a variety of financial and non-financial metrics and their interlink ages; capturing a longer-term perspective; and providing a better reflection of company strategy."

This begs the question of what metrics allow external users to evaluate a company's viability and the company's value proposition effectively. We classify non-financial indicators into two broad categories namely economic and non-economic metrics. Economic metrics focuses on the information which tells about the performance of the firm in its business. On the other hand, non-economic metrics are those which informs about the firm's involvement in other important areas like environment, society, social welfare etc. Recently investors and other stakeholders have shown more interest towards non-economic indicators rather than economic non-financial indicators. Corporate social responsibility (CSR) activity is an area of intense and increasing interest both on the practice and academic fronts. Due to this shift in the preference of information it is necessary for the firms to give such information to their stakeholders.

3. CONCEPTUAL FRAMEWORK

The choice of broad theoretical framework depends on whether the researcher approaches the question of CSR from an economic or an ethical standpoint (Cetin-damar and Husoy, 2007). Ethical theories indicate that these activities should be promoted because they are the "right thing" to do. Economic theories indicate that these activities should be promoted only to the degree that they create shareholder wealth through increasing profit. Virtually all theoretical approaches carry the implication that it is not enough to partake of a CSR action, it is necessary then to disseminate information about the action that has been taken. A matter of significant difference between the theories pertains to what actions should be taken, and who should be informed of them. To some extent, the answer to the first drives the answer to the second: if the primary goal of the activity is to enlist the support of a particular party, the firm will of necessity publicize the activity through channels likely to reach that party. Therefore, we should look into different theories which offer a brief overview of the "why" of CSR activity.

NEO-CLASSICAL ECONOMICS

Bird et al. (2007) adopt a traditional economic approach to the question, suggesting that managers should apply net present value (NPV) analysis to all potential CSR activities and take only the actions that result in a positive NPV and thus, increase shareholder wealth. An important element of this theory in the CSR context is the neo-classical notion that the shareholder is the only stakeholder of significant interest. A problematic issue for the traditional neo-classical approach to CSR is that unlike production decisions, CSR activities and their outcomes may not yield the mathematical tractability necessary for reliable NPV analysis.

MARKETING STRATEGY

Another stream of inquiry that suggests that CSR may be motivated mainly by wealth concerns is found in the marketing literature. Brown and Dacin (1997) provide empirical evidence that consumer beliefs about products are influenced by the information that they possess both about corporate ability (the producer's competitive advantage) and about the producer's corporate social responsibility, even though the CSR policies are often unrelated to the company's ability to produce. Both items are key elements in creating a good corporate reputation, posited by numerous theorists to provide a source of economic benefits to an organization. Brown and Dacin (1997) find that negative CSR perceptions are shown to exert negative effects on consumer behavior, while positive CSR perceptions exert positive effects on consumer behavior. Handelman and Arnold (1999) provide further evidence on wealth creation through marketing activities subsumed under CSR. They suggest that consumers appear to possess a demand for intangible factors indicating congruence with local social norms and values, and that the firm's promotion of these elements may yield a strategic angle equal to that of competitive positioning and product attributes. The marketing-oriented literature on CSR activity suggests these actions are a strategic tool to build and maintain customer loyalty and market share. The implications for disclosure are that the primary targets for information are the existing customers and members of the public with a general interest and that the content of the disclosure will be chosen to emphasize congruence with customer values.

POLITICAL ECONOMY

A third theoretical approach considers these actions through the lens of the political economy. In this approach the firm is not considered to be an economic entity that can be divorced from its social context; it is instead an organic organism that is a party to a social contract with the other members of its context. In order for the firm to survive, it must obtain the support and approval of its stakeholders, whether those be primary stakeholders (those without whose support the firm cannot function at all, including customers, suppliers, or providers of labor and capital) or secondary stakeholders (who are indirectly affiliated but in a position to significantly influence the firm's success, including regulators and media) (Clarkson, 1995).

Under this general heading, researchers have variously advanced theoretical arguments based on stakeholder theory (Clarkson,1995; Hooghiemstra, 2000; Maignan and Ralston 2002) and on legitimation (i.e., Gray et al. 1995a; Campbell 2000) to explain both CSR activities and disclosure.

Legitimation pertains to efforts on the part of the firm to establish, maintain, or repair public perception of its dedication to stakeholder norms and values, thus evincing respect for the "social contract" that permits it access to capital and labor markets and other economic resources necessary to ensure organizational survival. Dowling and Pfeffer (1975) outline three means to establishing or improving legitimacy: adapting operations to conform to existing societal expectations, altering social definitions to conform to existing firm operations; or engaging in communication to promote its public identification with socially legitimate symbols, values, and institutions. The degree to which the organization is visible and/or relies on social and political support drives the concern for legitimacy.

Closely related to legitimacy theory is stakeholder theory. Balmer et al. (2007) elaborate upon this view, stating that "…in contrast to the traditional legal/economic perspective, which disregards all non-marketplace interaction and avows that the corporation's sole responsibility is to maximize its shareholders' wealth, stakeholder theory takes a more pragmatic stance that sees shareholders as one among multiple contributors to the firm" and that this view indicates that management has a moral obligation to all contributors, not only the shareholders. Therefore, regardless of the motivation of an individual firm, the observable output is likely to be very similar: promoting a variety of CSR activities, and ensuring that the target population is kept apprised of this behavior.

INSTITUTIONAL THEORY

The recent upsurge in interest in CSR activities on the part of investors and customers raises the specter of yet another theoretical standpoint: institutional theory. Institutional theory suggests a process of organizational convergence. The isomorphic argument possesses implications both for CSR action and disclosure: to the extent that managers of contemporary organizations have been inculcated with the belief that CSR activity is necessary (for purposes of adding to market share, incrementing stockholder wealth, or for straightforward ethical principles) it is possible that the surge in this type of activity – and related disclosure – represents a form of normative isomorphism. To the extent that the upsurge in such activity is perceived by managers to be a competitive requirement irrespective of the need to deploy ethical principles or to derive gains from specific sources, it may be mimetic. Institutional theory also proposes selective use of information dissemination to direct attention to desirable factors and to deflect it away from controversial or unacceptable activities (Meyer and Rowan 1977; Elsbach and Sutton 1992). This suggests that CSR disclosure may be deployed in an effort to forestall undesirable regulation, or to emphasize what the corporation is doing "well" while downplaying what it is not. However, in an environment where CSR activity and disclosures are part of the accepted norm, the predictions of institutional theory converge with those discussed above: CSR activity will be undertaken and disclosed by any firms requiring the appearance of legitimacy as per political economy theory.

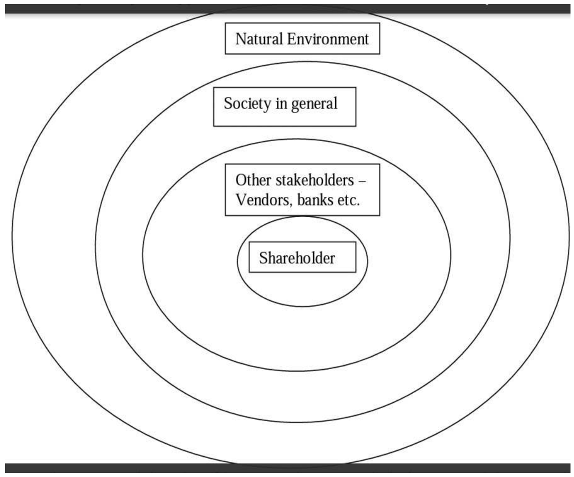
SHAREHOLDER DEMANDS AND INTANGIBLE ASSETS

An additional stimulus for disclosure may be categorized as a pragmatic management response to a demand situation. The intense growth in SRI assets suggests an increasing demand for CSR disclosures (and presumably, for CSR actions); these disclosures may be a simple response to the information needs of shareholders. Financial data is historical in nature and yields a limited perspective of the firm, insufficient to permit a sophisticated understanding of the firm's future prospects. A majority of top executives at multinational firms believe that non-financial performance measures outweigh financial performance measures in terms of creating long-term shareholder value (PricewaterhouseCoopers 2002).

While these concerns are relevant to the interests of all equity holders, they are of particular import to SRI investors. SRI investing does not disregard rigorous financial analysis; it simply adds to that analysis a consideration of the social and environmental consequences of the investments, such as environmental, health and safety, diversity, and human resources issues. Traditional financial statements are not adequate to supply the informational needs indicated by this type of investing activity. Many international companies have therefore responded by providing a variety of CSR disclosures.

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 environmental accounting, corporate governance, corporate social responsibility. This study talks about the paradigm shift in the philosophy of business from just concerned with their businesses to a broader approach which takes into account the environment in which the businesses operate. The new perspective has broken down the compartmentalization of business and society and it has been realized that social and environmental issues can no longer be addressed entirely through a unilateral imposition by the State through a legal framework. In the light of this new development, the business had to gear itself to rethink to develop new theories and practices of management to align itself with this breakdown. Besides this, the phenomena of a rapid decline in the role of the State and withdrawal of the State from the social space have created a vacuum. As the needs of the society and the imbalances in the society have not changed and therefore business has to emerge as the filler. The roles, relationships and realms of the three entities – the government, the business and the society have changed. The first implication is that this imposes a corporate responsibility of businesses towards society. This is indicative of a paradigm shift in the philosophy of business.

FIGURE 1: CORPORATE RESPONSIBILITY OF BUSINESSES TOWARDS SOCIETY



Earlier businesses could be formed and could operate successfully without including in their conduct anything that is a concern of society, beyond what is valued, created and delivered through the market. It was assumed that any responsibility that business had towards society is duly discharged through the market mechanism. Services, goods, raw materials and other resources that are drawn by business from society are adequately recompensed by the price established by the price mechanism. But with shift the philosophy of business which gives equal importance to society, in which it performs, and understand its responsibility towards society.

4. CONCLUSIONS

The reporting of non-financial information is gaining acceptance as the theories predict that in order to survive in the society the business have to consider the need of all the stakeholders which are affected by the actions of the business. Some of the other theories says that reporting of such information can only be there if a firm indulge in such activities and it would give a firm advantage over other firms and it can be a marketing strategy of the firm. But all the theories presented the view that reporting of such information cannot be ignored and if the business fails to report such information then the business will cease to exist sooner or later.

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