Non-Financial Reporting: The Firm and the Stakeholders

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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 different characteristics of a firm like size, ownership, control etc. The second part of this paper has reviewed the research articles emphasising on the use of Non-Financial Information by different stakeholders. It is seen that non-financial information is also of utmost importance for the stakeholders and characteristic of a firm determines the non-financial information which is disseminated by the firm.

Key Words: 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 there 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.

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 firms’ 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 reviewing and examining the literature on non-financial reporting.

In the next section, there is a review of relevant research papers. This is divided in different dimensions namely firm and stakeholders. Then there is a critical analysis of the papers reviewed then followed by conclusion.

2. Review of Literature
This review of literature has been divided in two dimensions in order to cover every aspect of non-financial reporting. Firstly, we focus on the studies which help in determining the impact of different firm’s characteristics on non-financial disclosures. Secondly, we focus on the studies which have analysed the uses of different non-financial disclosures for various stakeholders.

2.1 Non-Financial reporting and “The Firm”

This part focuses on the studies that explain the relationship between non-financial disclosures and the various characteristics of the firm including size of the firm, ownership of the firm, type of control in the firm and others.

A study done by Karim. et al. in 2013 explained how firm size and public/private affiliation (employment status) affect voluntary disclosure decisions concerning quantitatively immaterial non-financial information.

This paper presented 136 manager participants with 24 cues representing non-financial, realistic business events and solicited their disclosure judgments.

This paper used a median split of total assets and total revenues to determine “large” and “small” firms. This study tested two hypotheses - one for firm size and non-financial disclosure and other for employer status and non-financial disclosure using analysis of variance (ANOVA).

This paper found that disclosures are positively linked to firm size, but this paper could not find an employer status effect.

Although there is a vast literature on public firm managers’ voluntary disclosure behaviour (mostly involving large firms), there is little research regarding the voluntary disclosure behaviour of small or large private firm managers involving non-financial information. This study filled this gap. (Karim. et. al, 2013)

Another study done by Mahmoudian et al. in 2012 investigated the role of strategic and operational controls in motivating the broadness of the organization’s accountability definition and in turns its willingness to provide voluntary disclosure on environmental, social, and governance issues.

The basic premise of this research was that the existence of internal controls within the organization provides a higher degree of confidence in the integrity of the voluntary non-financial disclosures to ward off any disclosure risk that might occur from revealing poor performance results.

Strategic control evolves from the structure and characteristics of the board of directors. The board’s direction then cultivates operational controls through an environmental management system. Using archival data, they have studied the existence of two board characteristics (independent directors and CEO/Chair duality) and three components of an organization’s environmental management system (policy, training, and assurance).

Their study examined the internal characteristics that make an organization ready for reporting, in order to predict the organisations which are most likely to provide an early stage integrated report. Using a sample of 221 US firms from year 2010 with the highest dollar value of assets and a proclivity for transparency, the study identified internal characteristics that predict “readiness” for holistic accountability. They used multiple regression to test whether the study variables have significant influence on voluntary disclosure.

They found out that controls at the strategic and operational level are associated with “readiness” for transparency and a broad based accountability to its stakeholders. (Mahmoudian et al., 2012)

A study done by Cohen et al. in 201 aimed at extending the examination of disclosures of non-financial information pertaining to corporate governance and corporate social responsibility by exploring the supply of disclosures of non-financial leading indicators contained within the portfolio of public disclosures made by a sample of U.S. firms.

Non-financial disclosures are less heavily regulated than 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. These structural differences in the disclosure environments raise questions about assumptions over the similarity of corporate behaviour in this matter. The question of whether the generally understood influence of size, industry, and political costs on financial disclosure influence non-financial disclosures is an empirical question; this study represents an attempt to explore the applicability of extant understandings of financial disclosure behaviour to the arena of non-financial disclosures. They studied the reporting formats choosen by firms to convey
non-financial indicators (NFI) and whether size and industry have an effect on what is reported.

Research questions were based upon the extent and intensity of reporting, the means through which disclosures are made, and the effects of size and industry on reporting. The study involves a content analysis on the public disclosure packages of a sample of 50 firms domiciled in the U.S. and listed on major U.S. exchanges during 2004.

They found out that the sample firms make extensive and detailed disclosures about market share and innovation practices, and disclose other leading indicators broadly. They also found out that the sample firms commonly use mandatory filings to convey this information regardless of firm size or industry, with optional filings also used extensively. They also found out that retail investors were most concerned with non-financial disclosures that more directly affected future earnings such as the disclosure of leading economic indicators. (Cohen et al., 2011)

2.2 Non-financial reporting and “The Stakeholders”

In a study by Coram et al. in 2011, the impact of enhanced disclosure of non-financial performance indicators on financial analysts’ decision processes and the information they pay attention to while performing stock-price valuations was examined. These questions were addressed through a verbal protocol study that examined the information-processing behaviours and types of information used by analysts in valuing companies. The protocol analysis provided a detailed, descriptive analysis of the use of non-financial performance indicators in this task.

Verbal protocol analysis is a research method that requires participants to ‘think aloud’ while performing a task (Ericsson & Simon, 1993). Verbalisations are taped and then transcribed to be used as evidence about the decision-making and information evaluation processes. By using verbal protocol analysis, this study provided insights into information used in decision-making that cannot be provided by archival studies.

The results demonstrated considerable attention to non-financial performance indicators. They found that the attention was asymmetric depending on the trend-direction of the financial information. Financial information received greater attention when the trend was negative whereas non-financial performance indicators received greater attention when the financial information showed positive trends. Overall, these results explained the processes by which analysts utilise non-financial performance information in making valuation and subsequent investment decisions. (Coram et al., 2011)

A study done by Brazel et al. in 2009 examined whether auditors can effectively use non-financial measures (NFMs) to assess the reasonableness of financial performance and, thereby, help detect financial statement frauds.

This study was based on the premise that manipulation of NFMs is difficult than financial measures as the earlier can be easily verified in most of the cases. For example, auditors can effectively verify the number of facilities, retail outlets, or employees.

Their sample included 50 firms charged by the SEC with having fraudulently reported revenue in at least one 10-K filing. This study is valuable as it tried to examine the potential of NFMs in differentiating fraud firms with the non-fraud firms.

They found that the relation between reported financial performance and NFMs can differentiate fraud from non-fraud firms. Using a matched-pair sample of fraud firms and non-fraud competitors, they documented that fraud firms are more likely to report inconsistent revenue growth relative to their growth in NFMs, than the non-fraud firms.

In another study by Simpson in 2009, the role of financial analysts in interpreting and disseminating non-financial information to market participants was examined. To study this, the researcher analysed the association between analysts forecast errors and patterns of firms’ non-financial reporting. He also studied how the analyst processes non-financial information and how processing of information gets affected by scope and frequency of firms non-financial disclosures.

A sample of the firms in wireless industries from The United States and Canada was taken and the data for 51 firms across 1997 to 2007 was used. The technique of multiple regression was applied to get the results.

The results indicated that, on an average, analysts tend to under react to information in customer acquisition cost, average revenue per user and subscriber base. The evidence on analysts’ use of market share and churn rate was found to be mixed and the minutes of use per subscriber did not seem to be relevant either as a predictor of future performance or as a determinant of analysts’ expectations. (Simpson, 2009)
A study done by Ornes et al. in 2010 investigated the association between the extent of a firm’s Web-based non-financial disclosure and its cost of finance, considering both the cost of equity capital and the cost of debt capital.

They focused on non-financial disclosures available on a firm’s website in HTML format since it is comprehensive and accessible to all shareholders at low cost. The website content analysis was performed during the summer of 2002. The initial sample size consisted of 894 firms from Continental Europe (43 from Belgium, 97 from France, 84 from Germany and 43 from the Netherlands) and North America (209 from Canada and 419 from the United States). The sample included all non-financial listed firms belonging to the DAX70/DAX30 (Germany), SBF120 (France), Euronext Brussels 50 biggest firms (Belgium), AEX/MIDKAP (the Netherlands), S&P500 (US) and S&P/TSX300 (Canada). These firms are the largest ones in each country.

They assessed the relationship between web-based non-financial disclosures and the firm’s cost of equity and debt capital using multiple regression models.

Their results show that cross-sectional levels of web-based non-financial disclosures are negatively associated with cross-sectional differences in the implied cost of equity capital in both Continental Europe and North America.

Their evidence also bought into focus the impact of international institutional differences on the economic relevance of web-based non-financial disclosures, with stronger association of web-based non-financial reporting and cost of finance in countries with lower-quality mandatory reporting requirements. Capital market participants in such settings may need to rely more on additional information to supplement financial information in order to assess firm value.

4. 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.

Some studies which are talking about the factors that are affecting the disclosures of non financials, like size, industry, employer type, existence of control in the firm etc. are very limited. There can be more variables which may have a possible impact on the disclosure pattern by the firms. One of the studies found out that disclosures are positively linked to the size of the firm. Thus, it can be interpreted as firms which are large tend to disclose more non-financial information than the small ones. It has also been found out that employer status (that is whether the firm is private or public) of the firm does not affect the pattern of non-financial disclosures but in fact it reveals that the private firms are also disclosing non-financial information due to various reasons like this may increase their credit ratings in front of the lenders or they want to go public by issuing shares so they might be disclosing more. So, with the introduction of new variables it is not sure whether the result will hold good or not.

It is also pointed out in one of the study that the difference is not in the users of information as a user might just use the financial information and other user would use only non-financial and it may also be the case that a stakeholder may uses both financial as well as non-financial information. So the classification is on the basis of information rather than that of users.

The non-financial information used by different studies is taken from internal sources. The validity of information can be questioned as information can be changed according to the will of the reporting entity. But the manipulation of non-financial information which can be easily verified like number of retail stores is difficult as compared to financial information but other non-financial information like customer satisfaction or employee satisfaction can be manipulated and cannot be verified easily. So, relying on the information given by firms itself is questionable. Information provided by external agencies is more reliable than given by firms itself. External agencies like J.D Power give information regarding customer satisfaction for wide range of firms.

Non-financial measures are given more attention when trends in financial performance are positive so, it limits the scope of non financial information due to dependence on financial performance trends. But this is not the case with every stakeholder as users who do not have financial stake in the firm are not at all affected by financial performance so they still use non-financial information to interpret about the firm.

Non-financial information can be used by the stakeholder to validate the financial positive or negative performance. As pointed out by one of the study that trend in financial performance can be verified by trend in non-financial performance. For example if revenue of a firm is growing year after year so it should be supported by non-financial
information like increase in number of retail stores or any other parameter. If such information is not supported by non-financial or non-financial present an opposite case then stakeholders can doubt the financial results of the firm.

Now we focus on limitations of some specific papers:

In the study done by Karim et al. (2013), they have done their research with the sample taken of managers are from large firms whether public or private this limits understanding of small firm managerial behaviour. If a mixed sample was taken then the result would have been applicable to all kinds of firms whether small or large.

In the work of Brazel et al. (2009) there are several limitations. First, it is possible that fraud perpetrators have manipulated NFMs in the past and will manipulate NFMs in the future to make them consistent with reported financial results. Secondly, controlling of variables that are associated with fraud before is limited. Finally, the assessment of fraud is limited to just revenues.

In the research of Cohen et al. (2011), there is a shortcoming due to the data source use. A significant portion of the source data used in their paper is obtained from company websites which can be changed or substituted easily at the whims of the organization.

5 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 uses 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 the investor to justify their investment as strong non-financial information ensures sustainable performance of the firm.

Major limitations with non-financial information are of measurement and materiality. Few non-financials can be easily measured like number of retail stores or the diversity while others are not easily measurable like employee satisfaction or customer satisfaction. So, each reporting firm uses different criteria for measuring non-financials, which leads to the problem of non comparability with other firms. Other major concern is of materiality of non-financial disclosures 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 information as there are for financial information, then the non-financial information would be more reliable and comparable.

REFERENCES


