PERFORMANCE MEASUREMENT: FROM INTERNAL MANAGEMENT TO EXTERNAL DISCLOSURE

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Abstract

This work aims at understanding, first of all, the origin of the interest doctrine and companies have demonstrated in the so called performance "measures". For this reason, we try to focus on the enormous changes which characterized the latest decades and to understand their consequences on firm management. Once the relevance of new parameters as internal information is recognized, we wonder if it is worth including them in officially disclosed information. Some theoretical models are presented, in order to describe the use of performance "measures" and to define the main information categories to be given to external parties.

Keywords: Integrated Reporting, Non-Financial Information, Fordism, Post-Fordism, Performance Measures, External Disclosure

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1 Performance "measures": to the origins. From fordism to post-fordism

In the pre-fordistic era, the manufacturing system was based on the presence of a steam power machine, hampering and expensive, to which every other machine of the plant was linked. Therefore, each plant was conceived as a unique large machine, formed by the power plant and a limited number of machines working synchronously. Its functioning was based on theoretical principles, more or less directly derived from science and technology; it was not easy to adapt it to different and changing resources and to customer expectations. The basic knowledge had a theoretical nature. On the contrary, everyday practice was not relevant, because machines were not able to considerate it.

The discovery of electrical power allows the separation of single machine: the turbine motion is not directly transmitted to the machines, but it is converted into electrical power that can immediately circulate through a wide network, at low costs. This means that it is possible to operate an industrial plant virtually everywhere and not only in a specific place. The layout of the single plant can be modified, too: machines don't need to be all linked to a central power center. They operate in a more autonomous way and once merely mechanical schemes can now be adopted to specific contexts. Technological progress thus allows adaption to practical and specific needs: the ability in combining different machines in new and original ways now becomes critical. Thus, the fordistic firm can partially recover the "practical knowledge" characterizing the old handcraft laboratory. On one hand it standardizes micro operations splitting basic operations, but on the other it designs macro processes by considering individual skills. Practical knowledge allows differentiation and the firm can build its own competitive advantage. In fact, while theoretical knowledge is not so valuable

because everybody can have it, practical and contextual knowledge is specific, cannot be copied in a short time and in a cheap way, and therefore it can be defended. It depends on the entrepreneurial idea implemented within the firm and it is valuable only if the firm and it is valuable only if the firm itself is successful (Amigoni 1997).

The development of a contextual knowledge is feasible if the firm chooses among all the possible alternatives it must physically decompose complexity, by selecting specific opportunities and not other ones. Choices are irreversible because so are investments made and product characteristics. The selected course must be strictly followed, according to the decision taken. This is particularly true also because the existence of a specific know-how produces real benefits for the firm only if completely utilized. Therefore there is an incentive to exploit relevant investments made, in other ways not recoverable, by pursuing economies of information replication - i.e. economies of scale - and of information integration - i.e. , economies of scope. A strong tendency to dimensional growth is evident at this stage.

This is possible by utilizing a hierarchical organizational structure, based on centralization and co-ordination of the single parts of the firm through planning. In this period, hierarchical planning and budgeting systems, financial and cost accounting become the main tools. Remote control archetype is developed. It applies the assignment of objectives, based on accounting parameters to managers of different decentralized company units, given by the top management of the firm (Johnson, Kaplan 1987). These parameters constitute the foundations of evaluation and rewarding systems (Vancil 1979). Planning and control systems ensure efficiency to the firm, so that it moves towards the expected direction. In a relatively steady situation, in fact, "arbitrary changes represent dangers, constantly threatening business that do not have a plan. The weakest opposite wind can make a boat change its route, if it is not able to resist (..), *unpleasant route changes* can be decided under the influence of a serious but temporary disturbance (..), *planning protects the business* (..) against unwanted route changes, caused by serious events, but also against diversions, imperceptible at first, which end in turning it aside from its objectives" (Mintzberg 1996). The creation of an electrical power network allows to split physical operations: single locations where electricity is used become independent from each other. However, it is not possible to share the information needed to compose single operations as a system, through a network. For this reason, information is managed in a centralized way in large firms.

Transition towards a post fordistic system starts when technological advances allow the development of an information system to split information, too. Information technology tools, such as personal computers, Internet and Intranet communication systems, when utilized on a broad scale, allow the codification of knowledge developed in a certain place and its use by many people located in different sites (Amigoni-Ditillo, 1997). There are many implications of this phenomenon, because it allows to go beyond the fordistic model. New information technology allows: a) a virtual decomposition of complexity (of products, manufacturing processes, working stages and job tasks), obtained through the use of modular virtual objects representing single components of a product/process; b) a new composition of single parts through virtual components, in order to build tailored solutions using the same samples of virtual objects" (Rullani 1997). Information, like electrical power, should circulate within the system: as the latter allowed having separate manufacturing centers, the former allows having independent knowledge creation centers. Complexity is not a problem anymore, because the firm is not obliged to choose one solution once and forever, taking the risk to make hardly recoverable investments, aimed at following binding decisions with uncertain results. Instead, the firm is pushed towards the continuous generation of new complexity, by creating very different new alternatives. This is possible because manufacturing is not the focus of the entire process of creation any more, but it is only the final stage. On the contrary, the most important stage is represented by the use of "pieces of information" circulating "through the network", in order to try new possible solutions. As nothing "physical" is really created and "pieces of knowledge" are available within the network, investment in new tests is very cheap, virtually equal to zero, and it is possible to simulate different solutions to meet the expectations of different stakeholders, especially of customers. Firms must generate value for customers, by designing more and more tailored solutions, based on the analysis of their expectations. Firms nowadays pursue economies of differentiation (Rullani-Di Bernardo 1990, Beretta 1995). They originate from the fact that tailored products generate a larger amount of value for the user. What makes the new *modus operandi* possible and revolutionary is the reversibility of products; everything is possible until it remains in the "world of ideas" and is not concretely implemented. Therefore, the opportunity to generate new ideas and to create "new things" is systematically pursued: it is not a threat anymore, and it becomes a new lifestyle and a new aim for the modern firm.

2 The effects on the measurement system: from value "measures" to performance "measures"

Discontinuity, dynamism, chaos take the place of predictability and relative steadiness of the previous era. It is not important to control the present time anymore: the influence on future becomes strategic, instead. In this "upside-down world", managerial

theories are relentlessly swept away and must be radically thought over.

2.1 Value "measures" (or interprétation valeur): definition and limits

The firm is a resource-consuming organization, aimed at supplying products and services (Lorino 1995). Products have an economic value if they are able to satisfy potential customers' needs. This is possible if products have one or more functional elements, that is if they can satisfy a specific need. Each product can be considered a "bundle of functional elements" having a value only if there is a specific social group whose needs can be satisfied by those elements. Value is therefore generated by a subjective opinion expressed by a group, concerning the opportunity to transform some resources into functional elements. It is not an objective measure: it can be expressed by a price, but it is not only a price. Resources are worth being irreversibly transformed into functional elements. It is not an objective measure: it can be expressed by a price, but is not only a price. Resources are worth being irreversibly transformed into functional elements only if somebody believes that the value generated by the conversion is higher than the opportunity cost deriving from all other possible alternative use of the same resources.

The *interprétation valeur* or "value measures" (Lorino 1995) is therefore a judgment on the irreversible transformation which generated a specific combination of functional elements from a potential basket of resources, but it directly refers to the outcome, not to the transformation process.

This means that is not possible to use the idea of *intérpretation valeur* or "value measures" within the firm. In fact, the judgment, and therefore its manifestation through price, is formed when the firm relates with the market. When activities take place, value judgments are not certain, because they are based on functional elements that do not exist yet. It is crucial, for the firm, to understand if designed and engineered products, that is the expected resource utilization, will be appreciated by the market or not. In other words, the firms must be able to investigate how resources are converted into value. This need faces serious problems because no simple and direct relationship between the two elements, resources and value-generating functional elements, exist. The phenomenon of complementary resources makes the measurement of the contribution of a specific resource to value generation theoretically complex. The missing link through which the conversion of inputs takes place is represented by how activities are carried on and, moreover, by how processes – activity systems aiming at value generation – are structured.

2.2 Performance "measures" (or interprétation performance): the evolution of the concept

2.2.1 In Fordism, activities are black boxes and performance "measures" are directly connected with value "measures"

According to remote control paradigm, the issue is solved through the introduction of hypotheses about the working mechanism of the firm. They are thought to be simple, transparent and steady. In this way it becomes possible to predispose a model describing both the operational knowledge (activities) and the organizational knowledge (connections of activities). This model should simultaneously "describe" and "prescribe". Therefore, the consequent representation identifies the best decisional rules and suggests future behavior. In this "steady world", control does not need to understand specific situations, but to know the rule and to verify its application. Control basically means variance analysis between actual an standard amounts, the latter determined during planning and budgeting.

Variances are not value "measures", because they relate to internal circumstances. They basically represent performance "measures" – *interprétation performance* i.e., judgments on the ability of resources to contribute to value generation. In fact, variance analysis immediately and clearly points out relationships between each operating unit and income generation. The choice to express variances in absolute and not in relative terms stresses the wish to represent relationships in an explicit form, too. The actual content of activities (generating functional elements and, therefore, value) in terms of "knowledge and actions" is completely ignored in the analysis, because it is not considered interesting. In fact it is thought to be steady and describable in a model. Activities are still a black box.

Therefore, the control paradigm concretely becomes a managerial system, concerning resources and flows. Only measurable elements entering and exiting the black box are taken into account. None of all possible qualitative remarks on knowledge and transferred information is relevant, because they are not quantitatively measurable. This is the reason because, for instance, experience accumulation, changes in personnel motivation, new knowledge acquisition are ignored as non-events, as they do not leave any track on resources. The focus is exclusively on: a) transactions, that is resource transfer; b) allocations, that is resource distribution; c) exchanges with external parties.

2.2.2 In post-fordism, activity investigation is needed, because of complexity and unsteadiness

In previous paragraphs, we showed how simplifying hypotheses of control paradigm become absurd in

post-fordism. Post-fordism radically changes fordistic logical categories – to which control paradigm is linked – because information sharing concretely eliminates space, reduces time, increases the speed of communication among individuals.

It is difficult to defend the simplicity of the old firm model, in a world where complexity continuously increases. First of all complexity shows "in terms of system opening" (Lorino 1995), because more and more often, external elements become a constitutional part of the firm. This certainly happens in mergers and in explicit agreements (such as joint ventures), but, above all, through the creation of networks among firms through the internet. A network is formed by a certain number of subjects, by relationships existing among them and by shared information. The network existence is not necessarily dependent on a physical place, because it makes the most of virtual communication highways and therefore can connect different subjects located very far from each other. The membership of a certain subject in the network is represented by the generation, in conjunction with other members, of specific meanings and by the sharing of a common language. Within this new organizational form, a new job division scheme takes place: the knowledge based one. Basically, each network junction specializes in a specific function and the related knowledge is introduced in the network, so that other members can use it. The information and the communication potential of the network therefore continuously increases.

Entering a network has become a vital need for each firm, because none of them is able to generate sufficient knowledge to survive in post fordistic continuously changing and hyper-competitive scenarios. It is crucial to point out that entrance in a network is a necessary condition to survive but that it is not sufficient, though. No granted elements exist in post-fordism: everything is changing, including the network.

This situation implies a second kind of complexity so called "combinatorial" (Lorino 1995). This term indicates the trend to multiply the constitutional elements of the firm system. Information technology allows firms to obtain data, information, knowledge in a very short time and at low costs. This also allows the firm, but simultaneously condemns it, to increase the number of products offered, of technologies utilized, of markets entered. This is an opportunity , but also a need, because a hyper-competitive environment is created. The existence condition is therefore constituted by the ability of each firm to present itself to other network partners and to customers as an innovative subject. The firm must be able to continuously generate new ideas, because this is the only ability that makes it different from its competitors. In this sense, it is possible to state that post-fordism, on one side, generates energies and opportunities never thought before. On the other side, it is a source of anguish, though. The above described conditions clearly make the second hypothesis of remote control archetype – the steadiness of the system- difficult to be defended, too.

2.2.3 The focus on activities and processes

Dynamism stems from knowledge generation (Nonaka-Takeuchi, 1995). Learning means increasing the number of ways to face complexity and creates a potential source of progress. A contraries, new knowledge does not come from perfectly "structured and controllable" organizations, but from disorder and chaos. This implies to abandon certainties coming from the simplifying hypotheses of the control archetype, even if this generates anguish. On one side, the reduced possibility to make correct forecasts must be recognized. On the other side, the compression of the ability to generate new knowledge, characterizing the firm and allowing its survival, must be avoided. Activities cannot be considered black boxes any more: internal processes – creating, destroying and transforming resources – must be investigated. In order to understand how resources are transformed into value – generating functional elements, the concrete functioning of the "converter" must be studied. In other words, activities and processes, and how they really take place, must be considered as the basic analytic unit.

The word "activity" does not mean "physical effort", nor "action". The idea of activity is created by actors through a cognitive process – of acquisition and creation - consisting in knowledge codification. To make knowledge explicit, an interactive process among several parties is needed. Through this process, "the elementary parts" of activities (their most relevant elements) are individuated according to a judgment on how significant and communicable they are (Nonaka 1994). Actors choose only a part of their knowledge, in order to codify and communicate it. Metaphorically speaking, the concrete activity can be considered a complex image in which particularly meaningful and evocative characteristics are individuated. These characteristics, which according to the actors, distinguish the image and allow its reproduction-even though not perfect- are individuated through an interactive social process and constitute the new idea of activity. Therefore, the new representation of activities is not a steady, objective and universal model, as it was in the control archetype. The representation is a result of the interpretation: a) of several subjects (not of top management, but of operative people); b) specific for each activity (not universal); c) subject to modifications, in order to take changes into account (not steady).

Only individuated and codified activity parts can be analyzed and constitute firm management matters. The not expressed part of knowledge is implicit in

behavior and constitutes the actors' silent knowledge (Nonaka 1994). The existence of silent knowledge, on one side, and the need that actors give an interpretation and a codifications of activities, on the other, put into evidence the central role of single people and state how impossible is to exert a deterministic and absolute control on activities. Each actor, through his interpretative abilities and his specific knowledge, takes part in activity management.

2.2.4 Performance "measures" as a new logic category

The effectiveness of measurement in terms of inflows and outflows is reduced, in the cognitive independence of actors is recognized and activities-and their interpretation-become the focus of the analysis. The traditional role of economic and financial measures is modified. The most important thing is now "to look into the black box", in order to understand the cause of resources conversion into activities. They are not "the Alpha and the Omega of Control" any more, but they are now one among other useful diagnostic instruments. The ability to interpret activities and process is now critical. For this purpose, financial measures are not enough, though. I fact: a) a system of indicators has to be created; b) each indicator, financial or not, must be recognized the same importance. We are clearly facing a real revolution (Eccles 1991).

This particularly true if we think that the idea of performance "measure", or, better, of *interpretation performance* (Lorino 1995), becomes complex. According to the object of analysis: as it is not possible to establish a universal model to represent activities and processes we are not even able to objectively and absolutely individuate valuable indicators to evaluate all the aspects of the firm. The peculiarity of the indicator system depends on firm characteristics and strategic and organizational profile. They influence how each activity and process is carried on.

According to the subject of analysis: the recognition of cognitive autonomy induces to negate the existence of a unique way, universally accepted, to interpret the course of each activity and process observed and put into existence. Semantics, that is the concrete meaning attributed to each activity and to each indicator used to describe it, will be at last partially specific of each actor. Therefore, the choice of indicators to express a judgment on performance will be different in different situations. However, it is possible and necessary to put in evidence that judgment on performances have a general characteristic. They must be expressed while considering that, even though they refer to internal situations, they represent the attempt to anticipate another judgment of value: the customers' one at the moment of the purchase. Activity and process potentialities should therefore be appreciated, taking into consideration their aim: to satisfy customers' needs. All the attempts to give an understandable representation of the contribution of activities and processes to the generation of value are considered potentially relevant: they can be numbers, words, drawings, charts, gestures, actions. These expressions can be formally individuated or not. As far as the management of the firm is concerned it is necessary to identify some formal indicators . The need to add them to the traditional economic and financial analytical instruments does not imply at all that they must have an exclusively qualitative nature. The criticism to economic and financial indicators is in fact not related to their quantitative nature, but to the universal semantic meaning attributed to them.

3 Role of performance "measures" in internal information

So far, our considerations stated an important perspective change. Firm strategy cannot be decided first and then communicated to a reliable group of executors. The firm jeopardizes its market position every day. Day-by-day circumstances, single operational decisions, single actions of people operating at each level are important, because it is within each activity that knowledge needed by the firm to dominate its competitive arena is created, so that the target costumer segment is satisfied (Amigoni 1989). The relevant strategic meaning of daily work, transferred on operational details, becomes clear (Wheelright 1981). Therefore, a very detailed control system, verifying that goals established *ex ante* by the top management are achieved, is not useful anymore (Dearden 1969). Famous is the expression: "the use of financial measures to improve performance can be compared to watching the scoreboard during a football match: even if the board indicates who is winning and who is losing, it does not indicate how to play" (Eccles-Ryburn 1994). A system giving useful signals to let the firm understand "how to play" is needed. It should be able to learn, to generate new knowledge, to interact with external parties and in particular with customers, in order to identify the right direction to move to. It has already been pointed out that the design of a measurement system must be each time referred to the specific case. Nevertheless, firm theories proposed some general reference models (Tonchia 1996). Among them: the balanced scorecard or *tableau de board* approach (Kaplan and Norton 1993, 1996) separately considers different kinds of performance, corresponding to different analytical views, with no outcome aggregation; the pyramidal model (Lynch and Cross 1991), tries to create different synthetic levels of measurement. In the following paragraphs, we aim at identifying the main characteristics of these approaches, in order to understand how the already identified ideas are implemented. In other words, we try to understand

which kinds of measures are concretely used for internal control. The choice to limit the analysis to these two models is driven by the aim of this paragraph. It does not intend to be a complete treaty of performance measurement issues, but it is necessary to introduce the subsequent observations on the ways to transfer the same measures in documents disclosed to external parties.

3.1 The balanced scorecard model

The balanced scorecard approach (BSC) gives a useful framework, by translating the firm's vision in a set of performance indicators (Kaplan 1984, Norton Kaplan 1993, 1996). According to it, traditional economic and financial measures, representing outcomes of already taken actions, must be integrated by other measures that indicate factors generating future performance: customer satisfaction, internal processes, innovative and improving activities. The observation of such different indicator categories allows the identification of four complementary perspectives, through which management can determine control. The adjective "balanced" indicates a lack of hierarchy among different perspectives. They are equally relevant for control and they are synthesized through the "vision". A strong link among the four dimensions still exists, though, Moreover, they have the same dignity. As the financial perspective includes traditional value measures, attention is driven to the other three dimensions.

The first step towards the definition of performance measures according to customer's perspective is represented by the transformation of fundamental strategy into objectives the market can refer to. In other words, a process of demand segmentation, aimed at individuating customer groups with homogeneous needs, becomes necessary. The model identifies a group of performance measures – fundamental – which can be used in every firm, regardless of production peculiarities. First of all, market share. This indicator integrates financial perspective, because potential variances in sales amount can be understood, through a comparison with the competitors". On its own, the indicators does not give a sharp image of the ability of the firm to carry on activities and processes in the right direction, that is to full satisfaction of the individuated customer segment. Beyond this, other more direct indicators of customer satisfaction must be used. Those defined by the theory of the firm belong to two categories: field and desk. The former ones – field ones – are based on direct on-the-field investigation, such as interviews, questionnaires and other research methods. Their utilization lets the firm understand the perception customers have of the product utility and of its ability in satisfying their needs. These measures are focused "on the causes" of the achievement of a certain sales amount: the satisfied customer develops trust and tends to repeat the purchase. The latter indicators - desk ones - have a less informative relevance because they generate a less detailed knowledge sales, that is customer satisfaction, but "the quality of concretely obtained sales". These indicators only indirectly show customer satisfaction, because they measure the degree of customer loyalty to the firm – e.g., customer retention measures. They also give a quantitative determination of loyalty – such as life-time value and average ageing of accounts receivable. Even if desk indicators originate from the customer data base, that is from easily available quantitative data, this does not mean that they are more relevant than field indicators, for the construction of the balanced scorecard. The model identifies a second category of performance measures - called "off customers' proposition" – investigating the value attributed by the customer to the firm products. It is possible to achieve this result only through the analysis product service should be defined. That is: a) the functional elements off the supplied product; b) it is price; c) it's perceived quality. Secondly, the customer relationship attributes, that is the set off final activities off the value chain, must be identified. This are represented by shipping services, according to customers' needs. The emphasis off measures is on the temporal dimension, in order to monitor and to reduce, if possible, the so called lead time, which starts from the identification off customers' needs and ends with their satisfaction. Thirdly, the attributes linked to the imagine of the product- i.e., the set off intangible elements which generate a purchase- must be considered. We are now discussing several concepts, not new characterizing marketing activities of most firms. The recognition of a different role for them is new, though. Measures do not only relate to a specific function, but they are necessary for the firm being able, in the future, to transform its own resources into functional elements, appreciated by final customers and therefore convertible into value measures.

The balanced scorecard implies the identification of several measures to monitor processes – as system of activities aiming at value generation – mostly critical for the satisfaction of financial and customer perspectives. It is necessary to underline the great relevance of this analytical dimension - the internal process perspective - and of its systematic links with other ones. Some parameters allowing to express a judgment about activities and about processes must be evidenced. The final goal is always customer satisfaction. BSC implementation is characterized: on one side, by the width of the review of value chain processes; on the other side, by the preparatory role of goals set under this perspective towards other ones, thus representing the main operational translation of the strategy. BSC model proposes a classification of the processes into three categories, wishing to represent a generic value chain: innovative, operational and service processes. A great relevance is given to innovative processes. Focus on the definition of performance measures for this category of

processes has always been limited, because structurally not clear. In R&D processes, the relationship between inputs and outputs is not foreseeable and therefore it does not allow a control through variance analysis, as proposed under the remote control paradigm. It is possible to state that a firm innovation ability, which is the ability to generate new knowledge to better satisfy customers' needs, represents a critical element of BSC. It is the only signal of the real competitive advantage of the firm. Some categories of the measures are individuated: a) performance measures (e.g., the number of projects generated by some basic ideas compared to the total number; the percentage of sales deriving from a new product); b) time measures (e.g., the duration of the product life); c) cost measures (e.g., the total cost of a complete development process of a new product); d) stage measures, verifying the implementation of projects vs. the related plan (e.g., introduction of a new product vs. operating plan). A central role is obviously attributed to operating processes. This is the category of measures contemplated in the balanced scorecard, which mostly allow to put into practice the ideas previously expressed. The consideration of "operational processes" means directly taking into account activities and activity systems. Performance measures proposed by the model are inevitably different from traditional accounting techniques – such as variance analysis – classified within a different economic and financial perspective. As no simplifying hypothesis on the real work is allowed, because this is the object of the analysis, the entrance in the activity black box becomes necessary. Measures proposed to express a judgment on how activities and processes create functional elements and, therefore, value for the final customer, are represented by quality measures, on one side, and by time measures on the other. If we refer to the former ones, the consideration of quality does not imply the verification of the correspondence of a certain activity or of a certain product to specifications individuated *ex ante*. This would go back to a flow logic, typical of variance analysis. The consideration of quality, on the contrary, implies an evaluation of the ability to always satisfy customers' expectations, through the supply of zero defect products. This idea is connected to features, performance, durability, reliability, aesthetics, perceived quality, etc. The main measures of the process quality generally refer to specific firm quality programs, such as ISO conformity. The best known quality measures of operational processes are: the defective items per process rate, the performance rates (i.e., percentage of products ready for sale out of the total), waste, scarps, reworks, sales returns and the percentage of processes undergoing a continuous control. The use of time measures allows to understand how the way of carrying on activities and processes reduces lead time, starting from the receipt of a customer order and ending with his receipt of the product. This element is very relevant because firms shifted from warehouse logic to a just-in-time logic, allowing an increase in manufacturing flexibility and a decrease in working capital investments. Manufacturing cycle effectiveness is a measure used to understand this dimension. It is the ratio between effective manufacturing time and total cycle time. Total cycle time represents a sum of manufacturing, transfer, inspection, wait and warehousing times. Only manufacturing time, according to this logic, is value-generating. The last stage of the generic value chain identified by the model is service. Service includes repairs under warranty, return and substitution of products, technical assistance for the utilization of the product and whole automatic payment systems. All the activities performed by the firm to keep their customers – through continuous contacts – are included in this category, too. After sale services are particularly critical when the technological content of the product is remarkable, but they are however very important in all other industries, too. Service, in fact, represents a key element to link the firm activity to the customer's, so that a partnership is almost created. Performance can be evaluated in this case through time, quality and cost measures, similar to operative ones.

The last perspective considered in the balanced scorecard aims at individuating the strategic goals and the related measures linked to learning and growth of the organization as a whole. This is_the learning and growth perspective. Giving separate evidence to this perspective, the model recognizes the renewed importance of people and of their specific knowledge (explicit and implicit) for the success of the firm. It is a choice consistent with the post-fordistic scenario, where the competitive advantage of the firm is based on the ability to pursue differentiation and therefore on the ability of internal personnel to generate new ideas. Learning and growth of people concretely constitute the basic structure for the satisfaction of goals under the other three perspectives. The simplifying logic of control does not exist anymore and it is not possible to individuate a group of mere executors and a small *elite* of wise bosses, either. Therefore, it is not useful to put emphasis on the pure achievement of fixed targets. Measures must stimulate research and exploitation of new opportunities, at all organizational levels. In other words, ideas to increase process efficiency and performance for customers should come from front-line workers, i. e., from those who materially processes and directly relate with the customers (Simons 1995). A first category of measures aims at individuating personnel abilities. In particular, it is necessary to understand the degree of employees' satisfaction, because it represents a basic element to increase productivity. This result is usually obtained through an enquiry destined to all or to a part of the labor force. The enquiry aims at understanding the involvement degree of people in the decision process, the degree of encouragement to be creative and to utilize personal initiative, the effectiveness of a

specific performance evaluating system, the general degree of satisfaction relating to the job environment. Measures of personnel retention are added to this qualitative judgment. They express the ability of the firm to retain benefits coming from investments made to increase personnel skills. Measures of labor productivity – such as sales per person – which should, even if approximately, express the average contribution of people to the firm, are added, too. Moreover, the model puts in evidence investments made by the firm in order to increase individual abilities. On one side, quality and level of information instruments available to individuals should be monitored, as those instruments constitute potential "tools". On the other side, the need for training to increase specific skills should be put in evidence, so that the related available instruments are fully exploited. Initiatives related to the satisfaction of training need should also be monitored. Finally, useful measures to monitor the degree of acceptance and implementation of balanced scorecard control process should be predisposed. The introductions of a new evaluating system of strategic performances, accompanied by the use of performance measures according to different perspectives, certainly represent a factor for change, compared to the traditional context. However, it is desirable to verify that the balanced scorecard is not a sterile document, but that it really represent an instrument of *pilotage de l'enterprise*.

3.2 The pyramidal model

The balanced scorecard considers different analytical perspectives and places them side by side, without explicit stressing links among separate performance measures. The "pyramidal" approach, on the contrary, gives evidence to links, by gradually structuring a hierarchy of measures. In particular it implements the firm vision through three analytical levels (Lynch and Cross 1991). The first level defines market and financial goals for each business unit and strategies showing how to reach these goals are formulated. The second level defines goals for each operative system supporting the firm strategy, in terms of customer satisfaction, flexibility and productivity. Finally, the third level converts goals into specific operational criteria – quality, shipping, cycle time and waste – for each department or component of the firm system. The different structure of the measure performance system (MPS) aims at evidencing casual relationships among separate performance measures, collected at a lower level – "measures collected in trenches" – and more and more synthetic results, in order to show a detailed picture of the situation to the directors' board. The aim, though, even in this case, is not to bring everything back to economic and financial measurement, but to focus attention to parameters with different nature by recognizing them the same relevance. In fact, the firm vision is implemented at a first stage both through the consideration of financial aspects (mainly: profitability, ROI, cash flow), and through the consideration of "external measures driven by the customer" (among which: absolute and relative market share, distance from the main competitor, sales of new products, R&D expenses, etc.).

4 Role of performance "measures" in external disclosure

Changes described so far induced to wonder if the relevant parameters pointed out in management models, should constitute a *private property* of the firm or if they could be somehow included in external disclosure. Such question did not necessarily imply that the accounting model and indeed financial statements were useless to show the true and fair view of the situation of the firm in compliance with legal requirements and with generally accepted accounting principles. Academics started thinking that relevant performance measures could have been added to financial information with no substitutions. The idea that companies' values have been influenced to a greater extent by elements that are not properly represented in the annual report becomes common, together with the consideration that annual reports disclose too much financial performance and too little non-financial performance. Effectively they do not describe nor measure determinant aspects such as quality, customer satisfaction and environmental and social performance.

An important issue taken in consideration in this context was and still is to what extent third parties should be informed about the actual firm abilities. If performance measures, organized in different models such as the balanced scorecard, constitute the instrument allowing the implementation of vision and strategy, it can be wrong to reveal its content to third parties and, among others, to competitors. In other words the point is to understand to what extent a right of third parties to know and a convenience of the firm to disclose exist. The hope to succeed in creating a better relationship with the counterparts has been for long time slowed down by the fear to reveal critical information to competitors. More than this a too detailed information on future evolution could create great difficulties if forecasts do not come true. These certainly constitute strong and not disposable disincentive towards transparent and complete disclosure. On the other side the need of the firm to communicate in a transparent way, in order to obtain the maximum level of trust in its interlocutors, represent an incentive to insert all the useful information in the report, so that a better judgment on the firm can be expressed.

Academics and Standard Setters have gradually promoted benchmarks which show the relevance of the introduction of non-financial information in annual reports. Performance measures have therefore

officially been recently introduced in external disclosure. The process took some decades and the debate is still ongoing. We will here try to consider some of the main milestones which characterized the path towards the recognition of the role of *performance measures* or *non-financial information* in traditional financial reporting and in the other new or renewed forms of reporting.

a. "Basic qualities" in the financial statements. A focus on the Italian academic tradition

Since the beginning of last century Italian Scholars clearly declare that financial statements constitute the main tool available to external parties and to internal parties not directly involved in the management of the firm to understand the firm profitability. The word *profitability* here does not only indicate the achievement of a financial result sufficient to remunerate the share capital. The firm is profitable if the expectations of all institutional stakeholders are satisfied with internal resources, with no need to turn to external parties. This classical definition concentrate on three elements: a) the pursue of institutional interests; b) the autonomy; c) the duration in a changing environment, subject to a continuous evolution. Again, this concept is implemented on one side by evidencing that a firm is profitable if more than one goal is pursued: the competitive one, the social one, the economic one. On the other side, through the widening of the idea of institutional stakeholder, in order to include all the subjects able to give contributions to the firm an then not only stockholders, and employees, but also, among others, creditors, customers, suppliers and the public administration (Masini 1970, Coda 1988, Airoldi 1993).

The selection of goals to attribute to the financial statements, in fact, can be reasonably made in considering their relevance, in terms of knowledge, for those parties having a wide range of interests that deserve protection. These interests have a convenient representation only – or, anyway, mainly – in the financial statements official data. Such parties are: minority shareholders, commercial and financial creditors, co-operators and employees, customers, some private and public institutions involved in research, data processing and economic decisions. They expect from the analysis of the official financial statements and of other integrative data, and from their history, to find indications of the present and future situation, concerning every function of the firm, such as the profitability of the firm as a whole and of the core business administration, the liquidity situation and, in general, the monetary and financial conditions, the symptoms of the degree of effectiveness in achieving the combination of manufacturing process as a derivation of managerial and organizational circumstances, the equilibrium of financial and asset structures, in relationship with the expected economic results and with the industry and environmental conditions (Provasoli 1974, Riva 2001, Quagli Teodori 2005).

This means that financial statements should not only quantify the economic result achieved in the past, but that they should give sufficient information to appreciate its quality. The ultimate users of the document should be able to appreciate the ability of the firm to create or destroy wealth. This is essential for them, in order to satisfy their information needs and to subsequently interact with the firm in different ways – such as making decisions on investment, liquidation, stockholding, granting of credit, purchasing, co-operation, etc. – being aware of the firm position (Riva 2003, 2005). The aim of financial statements is therefore to "make quantitative and also qualitative representations, in order to facilitate their users to satisfy their *forecast* (…) and *judgment* needs about the ability of the firm to generate income" (Provasoli 1974). The financial statement is the tool used by the firm to convey to external parties its ability to generate value. From the financial statement, they can understand if such ability derives from exploiting casual opportunities or from superior skills in dominating selected market segments.

A fixed goal cannot be achieved only through the monitoring of quantitative measures, i.e., through accounting representations. A "financial statement system", in fact, cannot be considered only as a quantitative tool for income calculation and for asset and liability evaluation, even though these elements are still fundamental. As the financial statement system goal is to satisfy the ultimate users needs and the aim of the latter is to understand the situation of the firm in present and future times, economic and financial data have to be integrated. Qualitative information has to be added. This is represented by all extra-accounting collected data, such as statistical data and qualitative information in a strict sense. It is important to remember that the need to, add other information to the accounting data had already been clearly pointed out in the seventies in the Italian tradition. Masini, one of the founder of business Italian studies at that time declares, "business administration has much to do with quantities, but qualities have their relevance, too. Quantitative and qualitative analyses are complementary. The appropriate choice of elementary quantities and of *basic qualities* is the foundation of a firm information system" (Masini 1970). Performance "measures" are extra-accounting information and belong to the above definition of qualitative analyses or *basic qualities*. Therefore, they represent a natural complement to accounting information. The description of the *tableau de board* models in previous paragraphs allowed us to individuate the main performance "measures" used for internal purposes. In particular, the discussion on the balanced scorecard evidenced that other data must be added to economic and financial information, describing the customers'

attitude towards the firm, monitoring the most critical firm activities and processes, evidencing employees' potential and knowledge. Nevertheless, even after considering the very "aggregated" pyramidal model added to financial measures, some indicators of the firm market position must be considered. Indicators proposed by the two models aim at investigating the causes of value achievement by the firm, as they represent judgments on single activities and on process, that is on the converter of resources into functional value-generating elements.

4.2 Performance "measures" as information to be included in the "social report" in the seventies

The opportunity to include performance "measures" within a separate document has been deeply studied by supporters of social report. The aims of this document are however different from those pursued by inserting the same data in the financial statements. In order to support this idea, we must understand the origins and the goals of the social reports and which form they can have.

Social reports have inappropriately been called "reports". In Italy, they were formalized in the Seventies. In that period the social responsibility of the firm was noticed. This responsibility was towards all the subjects the firm interacts with: public administration, citizens, trade unions, employees, customers. The firm must demonstrate its social utility, that is, it must be able to demonstrate not to be managed against the above mentioned subjects, but, on the contrary, to act in their favor, respecting their needs. In other words, the firm management must not be in contrast with life quality of subjects operating within it or of those directly and indirectly influenced by the implementation of a specific manufacturing activity, but on the contrary, it must facilitate it. The meaning associated with social report was therefore in contrast with the meaning generally recognized to financial statements by the law in the same period as it was considered a tool necessary to show the economic results to stockholders.

Composing social reports, the firm does not supply a tool to give a better interpretation the quality of the result by indicating the strategies pursued and the ways pursued to reach them, but tries to demonstrate to each internal party that the firm is also managed to reach their interests and mainly that the outcome – regardless of its quality – is fairly distributed.

Social statement tradition developed at the end of the Seventies in France and Germany, thus originating two different models. In France, the yearly preparation of a social report was mandatory, according to law (Law no. 77/769). The social report was an autonomous document, summarizing "the main data allowing an evaluation of the firm situation under the environment point of view, the realization of what has been done and the measurement of changes happened in the closing year in comparison to the two previous years". Concretely, the French model did not aim at evaluating actions taken by the firm towards all the stakeholders: the main target group was constituted by the employees. The document therefore shows information concerning employment, salaries, fringe benefits, hygienic and safety conditions, other job conditions, training, industrial relationships, and also employees' and their families' life conditions, if they depended on the firm actions. The aim was basically to give a quantitative foundation of the dialogue among firm partners, allowing to measure the effort in social terms and to a better individuation of goals".

In Germany too, the social report was an autonomous document incorporating information concerning internal and external parties. It was divided into three complementary parts: social report which was a description enriched by statistics concerning goals and firm performances, and as far as it is possible, concerning output, achieved by social activities; value-added calculation which represented the link between the document and the traditional income statement; social accounting, the expression in amounts of quantifiable social expenses.

The acceptance of the preparation of the social report as an autonomous document – according to these two models – French and German – implies the radical discussion of the ability of financial statements to represent the satisfaction of stakeholders' needs. For this purpose, a specific tool predisposed according to a different logic appears to be necessary. Financial information seems to represent "technical considerations, hardly understandable" and that they are a result of a somehow "not reliable and not clear alchemy". The preparation of an autonomous social report seems to bring to the idea of the firm as a supportive organization which has to give back something to every interested part, but, isolating one of the aspects of the firm's life, the risk to lose the systemic vision gets higher.

The English approach was different from the French and German ones and closer to what the idea of an integrated reporting. The social responsibility of the firm is considered here not only in terms of "internal social" – relationship with employees – but above all in terms of "external social" - relationship with customers, suppliers, the environment. In 1937, the Confederation of British Industry predisposed a report on public firms social responsibilities. The document stressed the permanent validity of the profit parameter in judging the success or the failure of a company and therefore it considers the pursue of profit as one of the main firm goals. It is specified, though, that it does not represent the only one and even if others are not specified, it is pointed out that firms and individuals, too, have functions, moral obligations and duties going beyond the pursue of profit and of specific legal requirements. The success

in pursuing these different obligations and functions is therefore not necessarily measurable in terms of profit. The overall success of the firm must be evaluated by referring to the ability to achieve a balanced set of goals. In order to evaluate this kind of ability, the AASC (Accounting Standards Steering Committee) suggests the need to introduce other *indicators of behaviors* in firm reports, so that its social behavior towards community and national interest is expressed. AASC also stresses the existence of the right of an increasing number of social groups to receive information about the firm. A global approach to economic and social issues and to the substitutions of profit with the idea of maintenance of activities and of the elimination of waste in developing. The balance system based on this approach in structured into three fundamental parts (Douman 1975): an environmental section, concerning resources, physical working conditions, internal and external pollution; the traditional economic and financial section; a social and employees section, concerning attitudes and human relationships and including considerations on community welfare. The English approach, too, stressed the need for adding *behavior indicators* to report about the initiatives taken in favor of stakeholders. Focus is therefore again on value distribution.

b. The position of the US accounting bodies.

4.3.1. The "Model of Business Report" by AICPA in mid-nineties

It is important to examine the position of official accounting institutions about the issue we are here examining. American institutions paid remarkable attention to it.

The American Institution of Certified Public Accountants (AICPA) constituted in 1991 a specific Committee to predispose a report on disclosure (financial statements), evidencing the ways to increase its quality. The Committee did not represent an autonomous standard-setting body, but its relevance was remarkable, because it worked in conjunction with the Financial Accounting Standards Board (FASB – the American accounting standard-setting body), the SEC and other important institutions.

The Committee completed the document "Improving business reporting. A customer focus" at the end of 1994. According to it, the business report, that is the financial statements, has a central role in supporting the capital allocation decisions. For this reason, the related financial information is certainly critical. The Committee undertook a comprehensive study to determine the information needs of users to identify the types of information most useful in predicting earnings and cash flows for the purpose of valuing equity securities and assessing the prospects of repayment of debt securities or loans. The Committee designed the study to ensure that the findings were representative of a broad group of users and to distinguish between the types of information users really need and the types that are interesting but not essential.

The fast-paced changes in the firm environmental conditions and their width make financial statements obsolete, because they are not able to supply the requested information. According to the AICPA Committee, this is a big challenge. Firms are learning that flexibility is important to survive and that continuous change is becoming the new rule (AICPA 1994).

Therefore, even the business report – and the firm it describes – should be modified, in order to be updated according to continuously evolving needs of the users and to concretely face them. Anyway, Jenkin's study indicated that financial statements are an excellent model for capturing and organizing financial information. They package information in a structured fashion that permits analysis of a wide range of trends and relationships among the data. These trends and relationships, in turn, provide considerable insight into a company's opportunities and risks, including growth and market acceptance, costs, productivity, profitability, liquidity, collateral and many others. It is relevant the conclusion of the Committee: "no user suggested that financial statements should be scrapped and replaced with a fundamentally different means of organizing financial information".

The Committee document puts in evidence that people preparing financial statements would obtain a better result in forecasts of changes if:

a) they focused on information needs of third parties, whom information is destined to, by looking for efficient solutions to align them with the information contained in the financial statements;

b) they developed a reference model to supply such information and to maintain it constant in time;

c) they adopted a long-period logic, trying to understand the possible future evolution of third parties' needs, whom the document is directed to.

It is extremely interesting for us to describe the very operative rules suggested in mid-nineties by AICPA to modify financial statements towards the above direction. It is said that a larger number of piece of information on the future firm plans should be given. Opportunities, risks and uncertainties, characterizing the firm management, should be illustrated, the attention of analysts is focused on the future, but financial statements focus is on the past. Even though information concerning the past can constitute a good indicator of future evolution, analysts need forward-looking information. Basically, the Committee recommends to disclose some indications on the pursued strategy, so that reasonable forecasts on future scenarios are made possible. In this way, the users' need to "see the firm through management's eyes" and, therefore, to understand the

point of view of people governing the firm and the direction where they will drive it, is satisfied.

Moreover, it is necessary to better focus on long-term value-creating factors, through non financial measures indicating the "performance" of most critical firm processes. For instance, the inclusion of customer satisfaction indicators is encouraged. This is a critical step because it stresses the idea coming from management tradition that performance measures evaluating the ability of the firm to confers resources into functional elements – using Lorino's terminology – are relevant and therefore should enter the disclosed financial statements. Winners in the marketplace are the companies that are focusing on the customer, stripping away low value activities, and forming new alliances with suppliers, customers (and even competitors). They are setting the pace for others that must, in turn, re-examine their business in light of the increased competition.

It is suggested to try to better align the level and completeness of disclosed information to internal information, reported to senior managers for corporate governance purpose. In the United States the balanced scorecard and other measurement models are widely used for corporative governance purposes. It is therefore desirable that other indicators, concerning different perspectives – customers, internal processes, growth – are also communicated to external parties wishing to express a judgment on the future of the firm. Management should identify measures it believes are significant and meaningful to its business and that are leading indicators of a company's future.

In 1994 AICPA Jenkins' Committee presents a *"Model of Business Report - Major Components"* (Fig. 1) which is intended to be a proposal to compose annual reports useful to the readers. To reach the goal financial information should represent only a part of the story told and non-financial data represented by performance measurements and high-level operating data that management uses to manage the business need to be disclosed together with: management analysis of the information given, a set of forward looking specific information about plans, risks, opportunities, information about management and shareholders, and the background of the company.

I. FINANCIAL AND NON FINANCIAL DATA

A. Financial statements and related disclosures;

B. High-level operating data and performance measurements that management uses to manage the business.

II. MANAGEMENT'S ANALYSIS OF FINANCIAL AND NON FINANCIAL DATA

A. Reasons for changes in the financial, operating, and performance-related data, and the identity and past effect of key trends.

III. FORWARD LOOKING INFORMATION

A. Opportunities and risks, including those resulting from key trends;

B. Management's plans, including critical success factors;

C. Comparison of actual business performance to previously disclosed opportunities, risks, and management's plans.

IV. INFORMATION ABOUT MANAGEMENT AND SHAREHOLDERS

A. Directors, management, compensation, major shareholders, and transactions and relationships among related parties.

V. BACKGROUND ABOUT THE COMPANY

A. Broad objectives and strategies;

B. Scope and description of business and properties;

C. Impact of industry structure on the company.

Figure 1. Model of Business Report (AICPA 1994)

High-level operating data and performace measurements that management uses to manage the business will vary by industry and company. Management should identify those measures that it believes are significant and meaningful to its business, and that are leading indicators of the company's future. Non-financial information is important to understanding a company, its financial statements, the linkage between events and the financial impact on the company of those events, and predicting the company's future. Generally the disclosure of non-financial would be of quantitative measurements, assuming those measurements are sufficiently reliable for external presentation; however, companies should supplement quantitative measurement disclosures with qualitative discussions where meaningful. They help users identify trends affecting a business and thereby provide users with a forward looking perspective. Operating data are statistics about a company's business activities, excluding data reported in financial statements and related disclosures, which the Committee considers to be financial data. Operating data may be denominated in terms of a currency or in terms of units of products or service, number of employees, units of time, and others. Performance measures are data about a company key business processes. For example, they relate to the quality of products and services, the relative cost of

activities and the time required to perform key activities, such as new product development. The distinction between operating data and performance measurements is unimportant and some measures may fall in both categories. For example, productivity measures, such as the ratio of outputs to inputs, are both an operating statistic and a performance measure.

4.3.2 The document "Improving business reporting: insights into enhancing voluntary disclosures" by the FASB at the beginning of the new century in 2001

The publication of the document "*Improving Business Reporting – A customer focus"* in 1994 represented the starting point for the subsequent FASB research. In fact, in 1998 the body appointed to establish the US accounting standards initiated the *Business Reporting Research Project* with the purpose of continuing and extending the research of the Jenkins Committee, endorsing its suggestion whereby a further study of the voluntary information provided by companies would be appropriate. This project resulted in the publication of the FASB document entitled "*Improving business reporting: insights into enhancing voluntary disclosures*" in March 2001. The importance and at the same time the delicacy of this document may be better illustrated by referring to the process that led to its publication. It should, in fact, be noted that the examination of the Jenkins report in 1994 first resulted in the drafting and dissemination of an "*Invitation to comment. Recommendations of the AICPA Special Committee on Financial Reporting and the Association for Investment Management and Research*" in 1996, whereby the FASB itself disseminated the AICPA document and requested comments with reference to certain specific questions. The first and most important topic brought to the attention of the business community was the following: "*Should the FASB broaden its activities beyond financial statements and related disclosures to also address the types of non-financial information that would be included in a comprehensive business reporting model? Respondents' preliminary views about the committee's suggested concepts, elements, constraints, or other aspects of the Committee's model will be important input to the Board's consideration of the Committee's recommendations".* The responses obtained were for the most part negative: the information was certainly considered useful, but the rigid regulation of non-financial disclosures was not considered appropriate, nor was the obligation to adapt to new and probably very complex rules (FASB 2001) viewed favourably. Despite this, those in charge of the FASB, convinced of the need to oversee a topic deemed significant also by respondents, decided to do something new and different. Instead of moving, as usual, towards the drafting of a document having normative value, a broad research project involving many parties and concerning a large number of companies in various sectors was planned. At the end of the research, the publishing of a report without the value of an accounting standard but that would in any case represent a useful point of reference for companies was proposed. The 2001 document thus assumes a very particular role since it was issued by the FASB as an accounting standard, while the contents provide simple "examples of good communication" that therefore have no normative value. The document states that: "*The objective of this Report is to help companies improve their business reporting. By providing evidence that many leading companies are making extensive voluntary disclosures and by listing examples of those disclosures, the Steering Committee expects that more companies will undertake or expand their efforts of providing voluntary disclosures. The examples in this Report provide helpful illustrations of such voluntary disclosures. They do not present a list of recommended disclosures. Individual companies will need to determine their own appropriate, relevant, and useful voluntary disclosures*." Once again, the FASB encourages companies to improve disclosure and attempt to provide the categories of information illustrated in the document, information considered useful for current and potential investors to decide whether to invest or continue investing in the company.

The document "*Improving business reporting: insights into enhancing voluntary disclosure"* is not a FASB accounting standard and therefore does not require companies to provide non-financial information. On the contrary, the FASB wishes: on one hand to provide an example to follow, a possible "specific reference model for the sector"; on the other hand to suggest to companies a method for defining their own voluntary disclosure model.

The research conducted by the FASB involved sixty five experts cautiously selected and concerned between six and nine major companies each belonging to the following eight sectors: automotive, chemical, IT, food, petroleum, pharmaceutical, banking and textile. They were organized into five working groups responsible for the analysis of financial statements, as well as other documents issued by the companies in various situations (for example, quarterly reports, SEC filings, press releases, fat books, transcripts of presentations to shareholders, analysts and potential investors, websites). The groups worked under the coordination of the Steering Committee. The non-financial information contained in the documents examined was classified under six categories, five of which (the first) taken directly from the *Comprehensive business reporting model* of the AICPA: Business data; Management's analysis of business data; Forward-looking information; Information about management and shareholders; Background about the company and Information about intangible assets. In the report, best practices for each sector and each of the categories of analysis are

provided, that is examples of particularly significant non-financial information found in the financial statements analysed and therefore considered useful for the reader are shown in specific tables.

The Report provides a "*framework for providing voluntary disclosures*", i.e. it suggests to companies a logical process for identifying information material for investors or in other words that may be useful for investors and deciding whether the communication thereof is advisable or not. This framework is described in the following terms: "*1) identify the aspects of the company's business that are especially important to the company's success; these are the critical success factors for the company; 2) identify management's strategies and plans for managing those critical success factors in the past and going forward; 3) identify metrics (operating data performance measures) used by management to measure and manage the implementation of their strategies and plans; 4) consider whether voluntary disclosures about the company's forward-looking strategies and plans and metrics would adversely affect the company's competitive position and whether the risk of adversely affecting competitive positions exceed the expected benefit of making the voluntary disclosure; 5) if disclosure is deemed appropriate, determine how best to voluntarily present that information; the nature of metrics presented should be explained, and those metrics should be consistently disclosed from period to period to the extent they continue to be relevant*". The committee suggests proceeding by identifying the critical success factors of the company and understanding the relevant operative data performance measures used by the management to oversee the same. The non-financial measures used to govern the company and therefore for internal management purposes should be externally communicated consistently with the need to protect the competitive position of the company itself.

The document gives attention to the relevant topic of the competitive value of external communication. This is a highly interesting passage as it shows in summary the main benefits and costs of voluntary disclosure. Among others, the following main potential benefits are pointed out: "*lower average cost of capital; enhanced credibility and improved investor relations; likelihood that they will make better investment decisions (as user of other companies financial statements); lesser danger of litigation alleging inadequate informative disclosure and better defences when such suits are brought.*" Then, the following main potential costs are identified: "*competitive disadvantage from their informative disclosure; bargaining disadvantage from their disclosure to suppliers, customers, and employees; litigation from meritless suits attributable to informative disclosure*". The subject of loss of competitiveness of companies that voluntarily provide non-financial information is expressly addressed by the FASB. In particular, three factors resulting in this undesired effect are identified, these being the type of information, the level of detail in which the information is provided and the criticality of the moment in which the information is communicated. Although it is pointed out that this is a problem with no simple solution, which requires the judgement of the company, the need to improve and increase voluntary disclosure is clearly endorsed: "*In any case, the ability to limit disclosures of competitively sensitive information should not be used as an excuse to avoid making required disclosures*". Such improvement will certainly be necessary in order to compete in the changing context of the XXI century as: "*...business environment is changing dramatically, and at an accelerating pace. These rapid changes, some of them massive in nature, will manifest themselves as increasing and changing demands for business information and a larger role for voluntary disclosures. Accompanying this will be an increasing ability to supply more information. In addition, the existing regulatory and standard-setting systems will in all likelihood struggle to keep up with the changes. (...) One result will certainly be a demand for more thorough and reliable disclosure of information that will be helpful to investors in an increasingly complex and confusing marketplace*".

4.4 The introduction of non-financial information in European Financial Reporting provided by Directive 2003/51/EC

Policymakers have taken the issue into serious consideration. On 13 February 2001, the European Commission presented a proposal for a regulation (COM 2001/0044/EC) on the application of international accounting standards. The regulatory instrument was chosen since, unlike directives, it is binding in its entirety and directly applicable in all Member States without the need for implementing measures and without the option of introducing national variants.

The obligations arising from the regulation being issued, in relation to the consolidated financial statements of listed companies, would be added to the requirements of the Accounting Directives, which ensure a basic level of comparability for all European Union companies. At the same time, also thanks to the power granted to individual Member States to require or allow the use of IAS/IFRS for the unconsolidated financial statements of unlisted companies, the latter would also be incentivised to transition from the minimum requirements of the Accounting Directives to more sophisticated forms of financial reporting.

In implementation of the proposal of the Commission, on 19 July 2002 the European Parliament and the Council issued Regulation EC No. 1606/2002, which provided for: the *obligation* to adopt IAS/IFRS and the related SIC Interpretations for the *consolidated financial statements* of

companies listed on regulated markets in Europe; the effective date of this requirement for reporting periods starting from 1 January 2005; the *possibility* for Member States to allow or require the use of IAS/IFRS for the *annual financial statements* of *listed companies* as well as the *consolidated and/or annual financial statements* of *unlisted companies*. Following the approval of EC Regulation No. 1606/2002, a scenario was outlined whereby certain financial statements would be prepared in accordance with IAS/IFRS, while others would continue to consider the EU directives as the normative source. The European Parliament and the Council deemed it necessary to reduce the differences between the accounting information provided by the companies applying IAS/IFRS and that provided by the companies applying the EU standards and the related implementing provisions. For this purpose, on 18 June 2003, Directive 2003/51/EC was issued amending Directives 78/660/EEC (IV Directive), 83/349/EEC (VII Directive), 86/635/EEC (already amended by Directive 2001/65/EC) as well as 91/674/EEC, on the annual and consolidated accounts of insurance companies, to make them consistent with international accounting standards.

In particular, Directive 2003/51/EC: a) enables Member States to change the presentation of the profit and loss account and balance sheet in accordance with IAS/IFRS, with particular reference to the substance of the transaction or agreement recorded as well as the distinction between current and non-current items; b) enables Member States to allow or require the application of revaluations and fair value in accordance with IAS, also for assets other than financial instruments; c) *enables Member States to require the inclusion of non-financial information in the management report, such as environmental and social information;* d) requires common content of the audit reports of financial statements; e) enables Member States to allow or require insurance companies to use valuation at fair value for certain assets.

For the purposes of this study, it is of great interest to point out that also in Europe, precisely on the occasion of the introduction of international accounting standards to the national legislation of all Member States, the concept of "non-financial information" was expressly introduced for the first time. Even an EU Directive sanctions the importance thereof, including the same as one of the key points of change needed in order to make the annual and consolidated accounts consistent with international accounting standards. More than a decade of study abroad thus finally achieved official recognition even in the old continent.

It should be noted that in addition to recognizing the usefulness of non-financial information, explicitly listing this among the essential elements each Member State were required to focus its attention on, the EC Directive also suggests where the same should be reported. Not in a voluntary annex, as is sometimes suggested by practice and doctrine, but rather in the Directors Report or Management Commentary(Riva 2001). As an example of implementation we can consider legal information requested by the Italian law in the Directors Report after the introduction of the directive. Art. 2428, c 1 c.c. clearly ask directors to disclose in a balanced, fair and complete way about the company actual situation and forecasted performance if necessary referring the analysis to different sectors and describing main risks and uncertainties the firm is exposed to. Art 2428, c 2 c.c. highlight the importance of the request to directors making it plain that the report must be "customer oriented" giving to readers all the information necessary to understand firm condition. To reach the goal the law asks to disclose not only "finance" information but also "non-finance" information adding that these will certainly be specific for the firm activity and recalling directly among the others the measures giving details about environment and employees. More than this art.2428, c 3, n. 6 c.c. asks again to disclose about "the conditions of the firm, their evolution…and a reasonable forecast" and finally art. 2428, c 2, n. 1 c.c. request to put in evidence "research and development activities" carried out in the accounting period which is actually to give an evidence of the internal innovative processed.

4.5 The position of the International Accounting Standard Board

4.5.1. The "Conceptual framework for the Financial Reporting" by IASB and FASB in 2008

Historically, the IASB has focused its activities on the development of global accounting standards relating to financial statements. However, the *Constitution* of the IASC Foundation – paragraph 2 - provides for a broader focus in its first objective, which is to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and *other financial reporting* to help participants in the world's capital markets and other users make economic decisions. This objective is repeated in the *Preface* to International Financial Reporting Standards (IFRSs), which states within the section entitled '*Scope and authority of International Financial Reporting Standards*' that other financial reporting comprises information provided outside financial statements that assists in the interpretation of a complete set of financial statements or improves users' ability to make efficient economic decisions.

In September 2008 an Exposure Draft "*An improved Conceptual Framework for Financial Reporting*" has been prepared as part of a joint project by the International accounting Standard Board

together with the US Financial Accounting Standards Board and it sets out the boards' proposals for two chapters (*Chapter 1 "The Objective of Financial Reporting" and Chapter 2 "Qualitative Characteristics and Constraints of Decision-useful Financial Reporting Information"*) of their proposed common framework. It is worth add that the process started in July 2006 when the Board published for public comment a discussion paper on the topic and that same paper was also published by the FASB.

The two Boards jointly point out – in paragraph OB25 of the 2008 Exposure Draft – that financial reporting should include *Management's Explanations* and other information needed to enable users to understand the information provided. The Boards acknowledges that Management's Explanations of the information in financial reports enhance the ability of capital providers to assess the entity's performance and form expectations about the entity. Management knows more about the entity than external users and can often increase the usefulness of financial reports by identifying and explaining particular transactions and other events and circumstances that have affected or may affect the entity. In addition, financial reporting often provides information that depends on, or is affected by, management's estimates and judgments. This is why capital providers are better able to evaluate financial information when they are provided with management's explanations of underlying assumptions or methods used, including disclosure of significant uncertainties about principal underlying assumptions or estimates.

IASB and FASC published separately in June 2010 the final Document "*Conceptual Framework for the Financial Reporting*". In both editions of it published on International Accounting Standard and US Financial Accounting Standard websites, paragraph OB25 has been omitted, but meanwhile a specific Document dedicated to "*Management Commentary*" was on his way to be issued. This last was prepared on the basis that Management Commentary lies within the boundaries of financial reporting because it meets the definition of "*other financial reporting*".

4.5.2. The IFRS Practice Statement "Management Commentary. A framework for presentation" by IASB in 2010

The international Accounting Standard Board at the end of the first decade of the century – exactly on December 2010 - has issued a document called "*Management Commentary. A framework for presentation*" following the path used for standards even if it is a Practice Statement and not an IFRS. Indeed the process started with the release in October 2005 of the "*Discussion Paper. Management Commentary. A paper prepared for the IASB by staff of its partner standard-setters and others*" and then in June 2009 of the "*Exposure Draft ED/2009/6. Management Commentary*". The final 2010 Practice Statement provides a broad, non-binding framework for the presentation of management commentary that relates to financial statements that have been prepared in accordance with International Financial Reporting Standards (IFRSs). Consequently, entities applying IFRSs are not required to comply with the Practice Statement, unless specifically required by their jurisdiction. Furthermore, non-compliance with the Practice Statement will not prevent an entity's financial statements from complying with IFRSs, if they otherwise do so.

It is convenient to start the analysis by first considering the contents of the "Discussion Paper". It recalls "*IASB Framework for the Preparation and Presentation of Financial Statements par 13"* which clearly declares that financial statements are not, of themselves, sufficient to meet the objectives of financial reporting. To bridge the gap between what financial statements are able to achieve and the objectives of financial reporting it may be necessary for the financial reports to include additional information (IASB 2005, par 6). The Board considers requiring the disclosure of "*other information"* to help the financial reports meet their objective. However, the Board point out that this will be achieved only if companies provide clear and meaningful information, and avoid boiler-plate disclosures. The Board points out that the term boiler-plate in this context means a unit or section of writing that can be reused over and over without change. An entity could, for example, make a statement that 'it operates strong corporate governance practices'. This would be considered a boiler-plate statement because it is generic and does not relate the practices to the circumstances of the entity (IASB 205, par 7).

The role of *Notes accompanying the financial statement* is discussed and it is cleared out that they provide an investor with information that is essential to an understanding of the primary financial statements and their elements, whether recognised or not. On the contrary *Management Commentary – or MC* – provides an investor with information that puts the financial statements into the context of the entity and its operating environment. *Management Commentary* supplements and complements financial information, providing insights into an entity's performance that financial statements cannot, and should not, be expected to achieve on their own. This might be achieved through the presentation of non-IFRS financial information and non-financial information *tout cour*. IASB views Management Commentary as the primary component of the information within the term "*other financial reporting provided outside the financial statements*". It is information that accompanies financial statements as part of an entity's financial reporting. It explains the main trends and factors underlying the development, performance and position of the entity's business during the period covered by the financial statements.

It also explains the main trends and factors that are likely to affect the entity's future development, performance and position (IASB 2005, par 19).

The Discussion Paper clears out that Financial Reporting is a system of documents and it is composed by:

- the *Financial Statements* including Primary Financial Statements which comprise a balance sheet, an income statement, a statement of changes in equity and a cash flow;
- and the *Management Commentary*.

The 2010 Practice Statement finally defines the Management Commentary as *a narrative report that provides a context within which to interpret the financial position, financial performance and cash flows of an entity. It also provides management with an opportunity to explain its objectives and its strategies for achieving those objectives. Users routinely use the type of information provided in management commentary to help them evaluate an entity's prospects and its general risks, as well as the success of management's strategies for achieving its stated objectives. For many entities, management commentary is already an important element of their communication with the capital markets, supplementing as well as complementing the financial statements.*

To reach the goal management are requested to provide management's perspective of the entity's performance, position and progress, disclosing those information that is important to management in managing the business. These include *non-financial factors* which have influenced the information presented in the financial statements. Such information explains management's view not only about what has happened, including both positive and negative circumstances, but also why it has happened and what the implications are for the entity's future. More than this the statement asks explicitly to disclose *forward-looking information* aimed at communicate management's perspective of the entity's direction. This last are defined as information about the future as prospects and plans that may later be presented as historical information. This is why management is asked to explain also how and why the performance of the entity is short of, meets or exceeds forward looking disclosures made in the prior period management commentary.

Information in Management Commentary should possess the fundamental qualitative characteristics of relevance and faithful representation. Information in management commentary should also maximise the enhancing characteristics of materiality, comparability, verifiability, timeliness and understandability. It should be clear and straightforward focusing on the most important information and avoiding to be immaterial giving boiler-plate discussion and to duplicate disclosures already made in the Notes.

The IASB asks to include five elements in the structure of the Commentary.

- Management should provide a description of *the nature of the business* to help users of the financial reports to gain an understanding of the entity and of the external environment in which it operates. That information serves as a starting point for assessing and understanding an entity's performance, strategic options and prospects.
- Management should disclose its *objectives and strategies* in a way that enables users of the financial reports to understand the priorities for action as well as to identify the resources that must be managed to deliver results. For example, information about how management intends to address market trends and the threats and opportunities those market trends represent provides users of the financial reports with insight that may shape their expectations about the entity's future performance. Management should also explain how success will be measured and over what period of time it should be assessed.
- Management commentary should include a clear description of the most important *resources, risks and relationships* that management believes can affect the entity's value and how those resources, risks and relationships are managed. Management commentary should set out the critical financial and non-financial resources available to the entity and how those resources are used in meeting management's stated objectives for the entity. Management should disclose an entity's principal risk exposures and changes in those risks, together with its plans and strategies for bearing or mitigating those risks, as well as disclosure of the effectiveness of its risk management strategies. This disclosure helps users to evaluate the entity's risks as well as its expected outcomes. Management should identify the significant relationships that the entity has with stakeholders, how those relationships are likely to affect the performance and value of the entity, and how those relationships are managed.
- Management commentary should include a clear description of the entity's *financial and non-financial performance*, the extent to which that performance may be indicative of future performance and *management's assessment of the entity's prospects*. Useful disclosure on those matters can help users to make their own assessments about the entity's performance, position, progress and prospects. Management should provide an analysis of the prospects of the entity, which may include targets for financial and non-financial measures. This information can help users of the financial reports to understand how management intends to implement its strategies for the entity over the long term. When targets are quantified, management should explain the risks and assumptions necessary for users to assess the likelihood of achieving those targets.
- *Performance measures* are quantified measurements that reflect the critical success factors

of an entity. *Indicators* can be narrative evidence describing how the business is managed or quantified measures that provide indirect evidence of performance. Management should disclose performance measures and indicators (both financial and non-financial) that are used by management to assess progress against its stated objectives. Management should explain why the results from performance measures have changed over the period or how the indicators have changed. This disclosure can help users of the financial reports assess the extent to which goals and objectives are being achieved. The performance measures and indicators that are most important to understanding an entity are those that management uses to manage that entity. The performance measures and indicators will usually reflect the industry in which the entity operates. Comparability is enhanced if the performance measures and indicators are accepted and used widely, either within an industry or more generally. Management should explain why the performance measures and indicators used are relevant. Consistent reporting of performance measures and indicators increases the comparability of management commentary over time. However, management should consider whether the performance measures and indicators used in the previous period continue to be relevant. As strategies and objectives change, management might decide that the performance measures and indicators presented in the previous period's management commentary are no longer relevant. When management changes the performance measures and indicators used, the changes should be identified and explained.

It results clear that the *2010 IFRS Practice Statement on Management Commentary* recall and refers to the management tradition and quotes many of the aspects already highlighted in 1994 by the AICPA with the "Model of Business Report" and in 2001 by the FASB with its focus on Voluntary disclosure in the document "Improving Business Report". We can indeed say that it represent a clear result of the process here described which changed the role of "*performance measures*" from a strictly private tool to an essential set of information to be necessarily disclosed to be fully compliant with the international Standards and to what is more important to compose decision-useful Management Commentaries (Riva 2001, Menicucci 2012).

4.6 The IASB Management Commentary as a form of Integrated Reporting in accordance to the "IR Framework" by IIRC in 2013

In 2010 starting from the idea of the UK Prince's Accounting for Sustainability Project (A4S) and of the Global Reporting Initiative (GRI) the International Integrated Reporting Committee (IIRC) was launched with the aim to compose new guidelines, sharing the view that communication about value creation should be the next step in the evolution of corporate reporting. A Discussion Paper was distributed in 2011, a Consultation Draft of the document was released in April 2013 open to comment up to July 2013 and finally in December 2013 the *International Integrated Reporting Framework* was issued. The Document defines an Integrated Report as a concise communication about how an organization's strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value over the short, medium and long term. The primary purpose of an Integrated Report is indeed to explain to providers of financial capital how an organization creates value over time. It therefore contains relevant information both financial and other. In the context of the IIRC framework the focus is on the measurement and evaluation of capitals, where the term capitals refers to any store of value that an organization can use in the production of goods and services. The six capitals the IIRC framework proposes are the following: financial, manufactured, intellectual, social and relationship, human, natural. All the capitals are fundamental for the company to operate, as the capitals are ultimately the input of an organization's business model. Through its activity the company is increasing, decreasing or transforming the capitals (Busco Frigo Riccaboni Quattrone 2013).

It is interesting for our purposes to consider that the process which took to the final version of the document investigated the perceived interaction of the proposed Integrated Reporting with other reports and communications. Many respondents expressed concern about whether an Integrated Report is an additional report or whether the Framework applies to existing reports, as an enhancement of annual or regulated reports. Respondents requested that the relationship between integrated and other reports such as sustainability and financial reports be clarified (Summary of Significant Issues, 2013) to understand how an Integrated Report aligns with, refers to and avoids duplication with other reports and disclosures.

As a result some contents of the Framework have been changed to deal with the requests. In particular paragraph 1E "*Form of report and relationship with other information*" first recall that an integrated report *should be a designated, identifiable communication* and that it is intended to be more than a summary of information in other communications (e.g., financial statements, a sustainability report, analyst calls, or on a website) as, rather, it makes explicit the connectivity of information to *communicate how value is created over time*.

Immediately after it is clarifies that integrated report may be prepared in response to existing compliance requirements. For example, an organization may be required by local law to prepare a *Management Commentary* or other report that provides context for its financial statements.

In those cases the Framework plainly acknowledges that *if that report – i.e. the Management Commentary - is also prepared in accordance with the IR Framework it can be considered an Integrated Report.* If the report is required to include specified information beyond that required by this Framework, the report can still be considered an integrated report if that other information does not obscure the concise information required by this Framework. In other words an Integrated Report may be either a standalone report or be included but as a distinguishable, prominent and accessible part in another report or communication. For example, it may be included at the front of a report that also includes the organization's financial statements.

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