Standard Life Investments

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IS THERE NO ACCOUNTING FOR MANAGEMENT?

Key Note Address by Guy R Jubb, BCom, CA

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Madam President, ladies and gentlemen.

It was, for me, a great honour to be invited to give this keynote address today and it is a great pleasure to do so.

When I graduated from this University as a Bachelor of Commerce in 1973 I would never have dreamed I would be here today addressing such a distinguished audience. I was blessed with having the good fortune of an accounting faculty that included Eddie Stamp, Geoff Whittington, and Tom Lee, whose collective approach to accounting practice and theory was to accounting what the age of enlightenment and Adam Smith were to behavioural economics. They were truly enlightened, forward looking thinkers. My only regret is that I was too young to appreciate it.

There was one other faculty member who deserves a very special mention in the context of today's conference. He was Tom Robertson. Many of you – or at least some of you – would have known Tom - and known him far better than I. In my day, Tom was a lecturer and his chosen subject was management accounting. As a somewhat truculent undergraduate, even I looked forward to his lectures. He brought a blend of humour and reality that breathed life into accounting - and into management accounting, in particular. He even made variance analysis a fun filled exercise! His tutorials – and his pipe - brought a whole new meaning to "smoke filled rooms". Tom Robertson was very special.

As a fund manager who is now seasoned in corporate governance and stewardship I am tempted to say "there is no accounting for management" but lest I succumb to that temptation I should like to focus on three areas for debate and discussion. First, is the scope – the ample scope - for strengthening how companies account for their business model. Second, is the important role management accountants have in integrating the business model into the corporate governance framework. Third, is the legal definition of public interest entities – and the benefits accruing from narrowing the definition to those entities which are truly public interest entities in the eyes of society at large.

Accounting for the business model

The business model explains how value is generated, delivered and preserved. It is – or at least it should be – a dynamic and not a passive explanation. The business model accounting framework should provide a fair, balanced and understandable account of not only how value has been generated and delivered but how value is being generated and delivered and how value will be generated and delivered - and preserved - in the future. Investors are interested in all three time frames - the past, the present and the future. Investors need sufficient, balanced and reliable information to hold boards to account effectively for the stewardship for the assets under their direction. This lies at the heart of the UK Stewardship Code. Management accounting function has a central role in linking the inputs, activities, outputs and outcomes of the business model to the development and implementation of business strategy.

But today's business model isn't just about the shareholders – and rightly so. Today's business model recognises increasingly the impact of human capital and the wealth which is created for employees.

Today's business model recognises the wealth it creates down its own supply chain. And, importantly, today's business model recognises the wealth created for society. In each of these aspects of wealth creation, management accountants have a role to play in identifying the right metrics to measure the business model's impact.

It is worth saying a word about impact investing at Standard Life Investments. We are finding an increasing number of socially aware clients – pension funds and charities in particular - who are asking us to invest in companies that have a social impact. For example, in companies which have a significant proportion of their outputs related to social housing; and in companies which source their supplies from entities in developing countries which have acceptable working practices. The list of relevant social impacts is endless, and professional investors like Standard Life Investments have a responsibility to manage portfolios that meet and respect both the letter and the spirit of an impact investing mandate. To do this, we require decision relevant, reliable information in order to allocate the capital entrusted to us in a way that generates and preserves value for our clients on a "win, win, win basis" – they get the returns they want, both financial and impact, Standard Life Investments' business model benefits from the impact investing services it provides, and the investee company gets access to capital at a lower cost than it would otherwise do so. But to construct an impact investing portfolio we need information that goes beyond the traditional financial accounting model. We need information that quantifies and analyses how the business model's inputs, activities, outputs and outcomes are aligned with relevant social impact metrics. In short, we need management accounting information.

Integrating the business model into corporate governance

But it is not just investors who want and need this information. Boards themselves should be recognising the importance of all stakeholders, not just shareholders, to the achievement of a successful and sustainable business model. The rhetoric from boards is generally good but I question whether many of them get the information they need to do this properly. Perhaps an analysis of the hypothesised information gap lends itself to academic research.

Lord Browne, when discussing last month his new book – aptly titled 'Connect' - said that firms must "connect" with society and he highlighted that business is losing the trust of ordinary people. And he went on to say "mistreating any constituent of society eventually leads to collapse". Collapse, ladies and gentlemen, is not consistent with a business model that delivers and preserves value. I think Lord Browne is absolutely right to express this so clearly.

He also hit the nail on the head when he said that positioning many of these issues under the banner of "corporate social responsibility" has enabled companies to "detach the activity of communicating and being involved with stakeholders almost into a side pocket". I would have opted to say "almost into a back pocket"!

In my experience, the report to the board from its CSR committee tends to be tagged on at the end of board meetings, when the directors' appetite for debate and discussion is often running at a low ebb and lunch awaits. Only when there is a crisis does it move up the board's agenda – and then it is usually too late. Far better that today's and tomorrow's boards bring non-financial business model matters to the heart of their agenda. But to enable this, boards need decision relevant, reliable information. Financial accounting models will not generally provide this information – it is, after all, non-financial information in the main. Management accounting models can and should provide it. Management accountants should be bringing their influence to bear in shaping the board's agenda by presenting this information on a regular basis and in a manner that has not only internal integrity but also improves decision making from the board downwards.

The interaction of the business model, society and sustainability are brought into sharp focus by the Volkswagen scandal. At this stage one can only speculate about the root

causes of what has come to pass but one certainty is that the buck stops with the board – and in this case, the Supervisory Board. Did the Board know what was going on? It is damned if it did – for condoning unethical practices that breach the covenant of trust (now a very fragile covenant) between Volkswagen and society, as well as with its other stakeholders, which incidentally includes investors, employees, regulators, and Volkswagen owners. And it is damned if it didn't know – for falling to identify what has turned to out to be a critical business model risk that has crystallised in a catastrophic way with a catalogue of corporate woe that will grow like Topsy for years to come. The only winners will be the lawyers.

The Volkswagen saga tells the tale of corporate governance failure, in general, and effective risk oversight, in particular. With the benefit of hindsight, I just wonder how much time the Supervisory Board spent discussing its responsibilities to society and its corporate social responsibility.

But corporate governance is not the only discipline on the charge sheet. The Volkswagen saga also tells the tale of a failure of accounting for management - and a failure of management accounting. Based on the evidence to date, I am far from convinced that those charged with management accounting ensured the Supervisory Board received a fair, balanced and understandable account from management about its approach to emissions testing - and probably many other aspects of its societal and social responsibilities. And I doubt the Volkswagen Supervisory Board is alone in not getting such information from management accountants. The situation prevails at many, many boards, I fear.

Can investors be agents for change? Last year, learning lessons from the financial crisis, we at Standard Life Investments introduced a new section into our Governance & Stewardship Principles and Policy Guidelines that we use to evaluate the corporate governance of companies in which we invest. The new section is entitled 'Values and Business Practices'. It says what you might expect it say about the responsibilities of a board to ensure that a company adopts values that are consistent with the long-term success of the company. But it goes further than that – it says that we expect a board to monitor how its values are implemented and provide a meaningful account of how it – the board - does so. Sadly – but perhaps not unsurprisingly - few, if any, companies do so. And one reason why they don't is that they don't have the management accounting information to do so.

Therefore, I submit that in the same way that we as investors learned lessons from the financial crisis, the Volkswagen crisis gives management accountants an opportunity to learn lessons about how to account for the business model in a trustworthy, relevant and reliable way in order to help boards fulfil their responsibilities to their stakeholders. Management accountants – and those who lead them, Madam President – should seize the opportunity now, consistent with a professional responsibility to act in the public interest.

And where better to start than with the Global Management Accounting Principles (known as GMAP), which were prepared by the American Institute of CPAs (the AICPA) and CIMA. They were launched in 2014 concurrently with a joint venture to establish the Chartered Global Management Accountant (the CGMA), a designation to elevate and build recognition of the progression of management accounting. I am curious -how many in this room know about GMAP? And how many of you have read them cover-to-cover?

GMAP postulates principles focussed on four outcomes. First 'influence', where the principles have been designed to encourage integrated thinking, leading to better decision-making. Second 'relevance', where the principles provide guidance on identifying past, present and future information, including social, environmental and economic data. Third 'value', where management accounting connects strategy to the business model, helping organisations understand the impact of different scenarios on generating and preserving value. Last but not least, 'trust'. Stewardship builds trust. The principles recognise that credibility and trust arises from balancing short-term commercial interests against delivering long term value for stakeholders. I think even Lord Browne would be impressed by GMAP!

I do not want to be unduly critical since I understand useful progress has been made on a number of fronts but I must confess that GMAP have been –and are - invisible from my seat of stewardship. I have never seen reference to them in corporate annual reports and I doubt many audit committee members know anything about them. In the wake of the Volkswagen scandal, CIMA and the AICPA have an excellent opportunity to promote GMAP and the four focussed outcomes. They should do so with a loud and influential voice – a voice that is heard not only throughout their memberships but also in boardrooms and the global investment community. There is nothing to loose and the public interest has much to gain from GMAP being adopted and generally accepted around the globe. I look forward to hearing the cheers when GMAP's cloak of invisibility is lifted high.

Public Interest Entities

Reference to 'public interest' leads me to the need to re-visit the definition of 'public interest entities' in the European Union. Under European law, all companies incorporated in an EU member state – including subsidiaries of non-EU parents – with debt and/or equity securities listed on a EU regulated market fall within the definition of public interest entities, irrespective of their size or the nature of their activities. This definition is very pervasive and very important because the corporate directives and regulations emanating from Brussels, such as the Transparency Directive, EU audit legislation and the Shareholder Rights Directive, are applicable to all public interest entities. And hence the burden of corporate governance, audit reform and transparency arrangements is the same for all listed companies. So much for the mantra that, 'one size doesn't fit all'.

To my mind, public interest entities are those which have a meaningful impact on the general public – for example, major banks, utility companies, and major employers like Volkswagen. Consequently, to my mind, many listed companies - for example most companies listed in the FTSE 250 and smaller companies indices - are not public interest entities. Therefore I should welcome not only a re-definition of public interest entities by Brussels – let's call them 'significant public interest companies' - but also the introduction of a new and separate category of companies – let's call them 'shareholder interest companies' – for those companies that currently fall within the definition of public interest entities but would not meet the criteria for 'significant public interest companies'. A structural definitional shift to enable a more proportional approach to corporate governance, transparency and other related burdens would not only provide a public interest risk based framework for corporate reporting and governance standards in Europe but also send a strong political and economic message of encouragement to 'shareholder interest companies' to devote more of their scarce resources to generating economic growth and prosperity for their shareholders rather than complying with the more onerous public interest governance and transparency requirements. Redefining public interest entities should lead to a win-win scenario for all concerned.

I could envisage 'significant public interest entities' having to comply with corporate governance laws that would require a specific reference to their duty of care of society and the public interest, not just to shareholders. This would inject a new authoritative and legally binding dimension into decision-taking - particularly long-term decision-taking – in Europe's boardrooms.

To link this back to management accounting and GMAP, 'significant public interest companies' should be required to disclose, on a comply of explain basis, whether or not they adopt GMAP in their organisation when benchmarking and improving their management accounting systems.

Quality decision making needs quality information – and GMAP are designed to help organisations make better decisions to respond appropriately to the risks they face and to protect the value they generate for the benefit of shareholders and stakeholders, including society.

Likewise, the relatively light legal burden on 'shareholder interest companies' and a sharper shareholder focussed definition of their directors' responsibilities should serve to stimulate risk appetites by such companies that are consistent with sustained economic

growth for the benefit of their shareholders – the providers of risk capital – and European prosperity.

Conclusion

To conclude, the business model is a dynamic and not a passive concept. To survive, it has to adapt to change – and it has to anticipate change - in order to generate, deliver and preserve value in the future. Over the last decade, and particularly since the financial crisis, we have witnessed and are witnessing a change in the covenant between companies, their shareholders, their stakeholders and society. The process of change is, in my opinion, irreversible but it is not uniform across different types of companies and sectors – or indeed countries. Also, there is recognition that a successful business model has to serve all these vested interests and do so in a sustainable and responsible way.

The governance and accountability of business entities, which is essential to enable business models to manage their risks and opportunities effectively, also needs to adapt to change and evolve. The governance models need to give thoughtful consideration to not only the skillsets in the boardroom to make sure that they are appropriate to the entity's business model but also ensuring that they focus on the right risks and opportunities – in particular, non-financial ones - and have reliable, understandable and relevant information to enable them to do this effectively.

This changing scenario provides management accountants with an excellent opportunity to help companies embrace these changes by developing metrics and management information systems that enable boards to take well-informed decisions consistent with their business model's objectives and to provide an account to their shareholders and other stakeholders of how they have done so.

GMAP – Global Management Accounting Principles – have significant unfulfilled potential and provide a framework based on influence, relevance, value and trust that will stand the test of time as well as professional scrutiny. To enable this to happen, I challenge the leadership of CIMA and the AICPA to bring GMAP out of the closet and into the mainstream. This should reduce the risk of future scandals like Volkswagen, and generate enduring economic prosperity for all stakeholders, including shareholders, employees and society. GMAP holds the key to the future of management accounting and of accounting for management.

Madam President, ladies and gentlemen thank you very much for listening.

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Notes

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