THE CFO AND FINANCE FUNCTION ROLE IN VALUE CREATION

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Kevin Dancey
C.M., FCPA, FCA
CEO, IFAC

Charles Tilley
OBE, FCMA, CGMA
CEO, IIRC

Barry Melancon
CPA, CGMA
CEO, AICPA and CIMA

Countless organizations are in trouble amid the novel coronavirus pandemic. Many are rethinking their fundamentals—down to their purpose and business models. Financial survival is only one challenge. Existential threats are coupled with the ongoing needs to provide employee safety, deliver value to consumers, and partner even more closely with suppliers, governments, and communities. This adds up to the greatest threat to value creation in generations. The business community's response to these challenges will form the judgments of investors and society for years to come.

Success and the strong relationships and trust that come with it depend on a broad and long-term view of value creation that serves many stakeholders—not just shareholders. The Business Roundtable's statement on the purpose of a corporation—signed by 181 CEOs—affirmed this idea. Many organizations are pivoting from legacy business models to meet new needs, as we see with automakers, retailers and others converting their facilities to make vital medical equipment. It is an excellent example of businesses learning to succeed while meeting society's critical and systemic challenges, which include climate change, inequality, resource scarcity and ecosystem disruption, alongside COVID-19.

However, as this report explores, many chief financial officers (CFOs) are caught in an old paradigm in which financial information and returns to shareholders are the primary measure of performance and success. A short-term capital markets mindset often results in narrow measures of value creation. Broader information on value creation covering critical assets such as people, innovation, data and key relationships; environmental, social and governance (ESG) factors; and wider impacts, are needed to serve all key stakeholders better and more sustainably.

Taking on a wider value creation lens will boost the CFO and finance function's contributions as effective partners within an organization. CFOs and their teams can pivot by shifting their focus and enhancing their capacity. This involves continually evaluating how traditional finance and accounting work is done, investing in upskilling and talent management, and focusing on the needs of the business in the context of external trends and stakeholder expectations. An exclusive focus on financial information and performance constrains the potential of the CFO and finance team to support effective decision making and reporting.

As Mervyn King, Chair Emeritus of the International Integrated Reporting Council, put it, "the CFO should be known as the CVO – chief value officer". In this role, the CFO adopts a comprehensive value creation and protection mindset and focuses the business on optimizing and protecting stakeholder value. A CFO with a broader mandate in value creation accounts for and communicates all relevant information about value creation and protection to boards, management, and external stakeholders.

With this more dynamic and expansive mandate of the CFO and finance team in mind, the central question becomes how to better understand, measure, and report on value creation. Integrated reporting is a well-established framework that supports just that. It also encourages "integrated thinking" within organizations, which creates and strengthens channels for information sharing in management reporting, analysis, and decision making. But a reporting framework alone is insufficient. CFOs will need deep knowledge of their organizations and the expectations of internal and external stakeholders to speak to its purpose, strategy, risks, opportunities, business models, and relevant resources or capitals.

This report sets out our thinking on how CFOs and their finance teams can redefine their roles and achieve this transformation.

ABOUT THIS REPORT

This report sets out our current thinking on how CFOs and their finance teams can go about accounting for and communicating value creation for internal and external stakeholders.

This thinking enables CFOs and their teams to focus on:

- Understanding value and how value creation is defined, created, delivered and sustained; and
- Measuring and tracking performance covering three interconnected value creation perspectives: balance sheet, business, and societal value.

The approach laid out in this report, and a supplementary report, Understanding Value Creation, helps CFOs and finance teams to ensure that all relevant information around performance, opportunities, risks, and trade-offs are available to internal decision makers and to investors and other capital providers. It also enables the corporate mindset to evolve from short-term shareholder value creation to long-term stakeholder value creation.

Additional resources on value creation from the global accounting and business communities are available here.

VALUE CREATION – THE FOUNDATION OF EFFECTIVE BUSINESS PARTNERSHIP

Value creation is the key for CFOs and finance functions to become effective partners rather than being perceived as a back-office function. To be considered an effective business partner, the CFO and finance function need to understand and communicate how their organization creates and protects value today, and how it will do so in the future.

Achieving sustainable long-term growth and value creation has never been more challenging. Customers and society are demanding more from businesses. A digital, data-driven, resource-constrained, and post-COVID-19 world presents much uncertainty in which there is enormous opportunity and risk. The CFO and finance function need to help navigate, measure, and communicate what matters to long-term success while dealing with the expectation for short term resilience and performance.

To steer a business today involves taking into account a broad range of stakeholder interests and other factors that will ultimately, if not immediately, impact financial performance and shareholder value. While accounting for the balance sheet will always remain important, not least in preparing for and managing through difficult times, performance and value cannot be adequately captured and measured in financial terms by the balance sheet or by financial shareholder value metrics.

Success requires creating and demonstrating value for all stakeholders, not just shareholders, and addressing societal expectations related to sustainability and broader impact, including a company's contribution to the Sustainable Development Goals (SDGs). For public companies, more effective communication of the drivers of value creation will affect not only market value, but also society's perceptions of the company.

Organizations are adopting this broader focus to decide how to adapt their operational and business models to respond to, and get ahead of, the COVID-19 crisis by protecting the interests of their key stakeholders. Today's crisis shows more than ever the need to account for other capitals (e.g., human, intellectual and natural capitals) in a connected way that leads to a broader value creation for others.

Driving adequate returns to investors at the same time as delivering value to customers, employees, and suppliers, and respecting society's interests and preserving nature, is a challenging juggling act. CFOs and finance functions need to ensure that all relevant information around value creation and performance, opportunities and risks, and trade-offs is available to internal decision makers and to investors and other capital providers to steer an organization towards its business objectives.

Digitalization and data provide a significant opportunity for CFOs and their teams to become more effective business partners (see the IFAC report, A Vision for the CFO and Finance Function). The enhanced role the CFO and finance function can play in accounting for value creation will result in a stronger and more effective finance and accounting profession at the heart of organizations.

For finance and accounting professionals, it is a rewarding albeit challenging journey because understanding and communicating value creation is a iterative undertaking, not an exact science. Prevailing ideas on measuring many aspects of value creation are evolving, and these efforts involve engagement among people from a wide range of disciplines and perspectives.

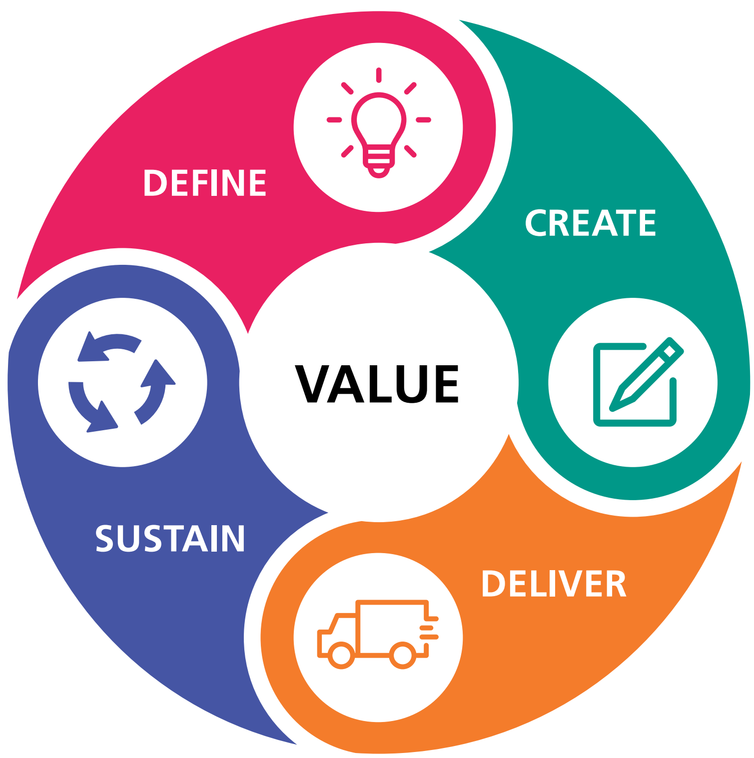
UNDERSTANDING VALUE CREATION

Before being able to measure, track and communicate on value creation, it is important to understand value creation through the lens of stakeholders and how value is created through purpose, strategy, and the business model.

This can be achieved through a management process of defining, creating, delivering and sustaining value. These components help to build a complete picture of what value creation means and how it is delivered to stakeholders incorporating:

- How value is ***defined*** by customers, investors and other stakeholders. This involves stakeholder engagement and provides the basis for identifying value creating topics and connecting purpose to stakeholder outcomes and measures of success.
- How value is ***created*** through the organization's purpose, strategy and business model taking into account all resources, capitals, and relationships in an integrated way.
- How value is ***delivered*** to customers, governments and society through responsible products and services, and new channels to market, all at an appropriate cost and price. The way value is being delivered is changing rapidly through technology, digital and data, and in the current environment, operating and delivering value virtually.
- How value is ***sustained*** by retaining and protecting value internally in the organization and distributing value externally by appropriate reinvestment and distribution to shareholders and wider society. Ideally, there needs to be a balanced approach between the retention of value derived by the organization and the distribution of value to its stakeholders aligned to its purpose and value objectives.

Each of these areas, which are explored in more depth in our supplementary report, Understanding Value Creation, informs strategy, goals, metrics, and incentives.



AN INTEGRATED VIEW OF PERFORMANCE AND VALUE

Given value creation cannot be sufficiently captured and measured in financial terms, various other value and performance perspectives need to be tracked, connected and analyzed. This includes value and performance through the lens of the organization, from the perspective of shareholders and the overall market, and the perspective of communities and society.

A corporate performance and value scorecard needs to draw on three perspectives of value creation that are the basis for a comprehensive and integrated corporate performance measurement and reporting system (set out in the diagram below):

- **Traditional accounting perspective:** Balance sheet (book) value – an accounting value derived from capital employed and provided, and represented by the financial statements.
- **Investor's Perspective:** Business (expected) value – derived from strategic and intangible assets that generate future growth and provide the basis for residual income, sustainable earnings and valuations, and reduced risk.
- **Society's Perspective:** Societal (sustained) value – representing the positive and negative impacts of an organization's activities on customers, employees, society, and the environment. External impacts can be quantified and monetized but are not yet reflected in the cash flows of the company but represent future opportunities and risks. Relevant non-financial impacts will at some point in the future impact cash flows and financial performance and be priced by investors and capital markets.

UNDERSTANDING VALUE BEYOND THE BALANCE SHEET

Value Perspective			IR Capitals	Key Value Drivers
Societal Value Purpose Contribution to the SDGs Reputation License to operate	**SUSTAINED** *Future* →	**Positive net contribution to society:** Economic value quantified & monetized	Natural	• Environmental resources & processes
Business Value Intangible assets & ESG factors that drive competitive advantage Assets with continuing value, but written-off Contingent liabilities	**EXPECTED** *Forecasted* →	**Strategic value:** Earnings & future cash flows Reduced risk	Societal & relationship Intellectual (Organizational) Human	• Brand • Customers • Suppliers & partners • Communities • Data, technology, systems, & network effects • Intellectual property • Governance & leadership • Workforce & people • Know-how
Balance Sheet Value Net current assets Tangible assets Recorded intangible assets Liabilities	**BOOK** *Current* →	**Financial performance:** Profitability and returns	Manufactured Financial	• Operational & infrastructure • Financial & physical capital employed & provided based on IFRS/GAAP and non-IFRS/GAAP information

Integrating and connecting these three perspectives of value is critical to understanding, monitoring and communicating the value creation process. The way performance and value are evaluated today is generally disconnected and siloed with financial analysis often divorced from wider value drivers and broader impacts related to contribution to stakeholders and society.

An integrated approach leads to shared value and creates accountability to all stakeholders. For companies and their investors, forecasting future earnings and cash flows will be a flawed exercise unless all relevant aspects of value creation are accounted for.

Long term cash flows and earnings will be impacted by how well intangible assets and other forms of capital are nurtured and managed, and by how performance in ESG dimensions creates long term value for various stakeholders. Much of the basis for long term value creation is not financial or manufactured capital but rather stakeholder capital or resources such as human, social and relationship, and natural capital. ESG strategies increase or decrease the expected value of a company's tangible and intangible assets, and create positive or negative societal impacts. For example, responsible products can drive revenue; efficient and low-carbon production and processes reduce operating costs; investments in people, talent, and diversity improve productivity and innovation; and socially-acceptable practices in the supply chain and among communities ensure the license to operate. All these factors ultimately enhance brand value and reputation.

A comprehensive value creation process requires a mixture of measures and indicators (financial, non-financial or pre-financial) relating to book, business, and societal value.

Metrics and KPIs capture key "value drivers" and related opportunity and risk factors that affect the prospects for future net cash inflows to the company. Some will be financial value drivers derived from the balance sheet and profit and loss statement. Others will relate to other forms of capital and resources that enable strategic value and ultimately competitive advantage.

However, metrics and KPIs that track the private gains and losses for the organization (i.e., do not capture externalities) are insufficient. Broader positive and negative impacts on customers, employees, communities, and the environment provide a wider perspective on societal value. Quantifying and monetizing such impacts enable decisions to be made related to the relative outcomes of the organization's activities on its key stakeholders and on nature.

Consequently, a performance and value scorecard is multi-dimensional with various types of metrics, KPIs and monetized information to track drivers of performance and value creation. All this information needs to be placed in the context of external trends, stakeholder outcomes, purpose, strategy, the business model and plans for short- and long-term capital allocation.

THE KEY COMPONENTS OF PERFORMANCE AND VALUE

Developing relevant and reliable information related to relevant value drivers can be a significant task. Therefore, metrics and KPIs must be useful to the organization, but also be effectively communicated to investors and key stakeholders. Aligning internal management metrics and KPIs with those communicated externally reduces complexity and focuses both the organization and its stakeholders on relevant issues. It also creates a transparent way to tie management to the delivery of objectives and outcomes.

Developing and maintaining a measurement approach and scorecard involves identifying metrics and KPIs that are decision-useful, including being:

- Relevant to value creation objectives and stakeholder outcomes
- Connected so there is link between strategy, the business model covering all relevant capitals and resources, key value drivers, and financial performance
- Sourced from across the organization requiring cross-department cooperation and collaboration
- Manageable in number but incorporating both leading (predictive) and lagging (historical) insights
- Developed through robust data collection processes and associated controls (the World Business Council for Sustainable Development and Danke Revisorer (FSR) published ***Guidance on Improving the Quality of ESG Information for Decision-Making, Developing a Roadmap for Companies***, which highlights rigorous internal control procedures for ESG information)
- Standardized and consistently calculated (using global standards and frameworks where possible) and highlighting key assumptions (e.g., in valuing impacts)
- Incorporated into planning and forecasting, risk management and investment appraisal, and wider decision making
- Linked to incentives and remuneration.

EXAMPLE SCORECARDS

ROYAL SCHIPHOL GROUP

Royal Schiphol's Management Agenda aligns all activities within the Group to ensure a focus on the most value-adding activities represented by the 'Top 8' performance indicators across five key focus groups: local residents, passengers, airlines, employees and shareholders. The 2019 Management Agenda and KPIs are available in its **2019 Annual Report.** Various operational metrics and measures sit below these KPIs.

SOLVAY

Solvay, an advanced materials and specialty chemicals company, captures value through a limited number of financial and non-financial KPIs presented in an integrated **scorecard**. A blend of reasonable and limited assurance is provided for social, environmental and other sustainable development information provided as part of its **annual integrated report**.

A starting point is to identify, define and evidence the resources or capitals (see the six capitals of integrated reporting) that are key business inputs and dependencies, and drive performance and value. Tying these to value creation and financial performance involves linking value drivers to revenue growth, operational efficiency, brand and reputation equity, cost of capital and risk.

The key areas of a scorecard will include metrics, KPIs and quantified or monetized data in the following areas:

BALANCE SHEET VALUE

- The balance sheet reflects book value based on historical or fair value transactions with which accountants and financial markets are familiar. Financial performance information is derived from IFRS or GAAP accounting, and often includes supplementary financial information covering alternative performance measures (e.g., non-IFRS or non-GAAP) reflecting profitability and returns, asset quality and liquidity.
- The balance sheet does not reflect those strategic assets and intangibles that are a source of competitive advantage and the basis for expected value creation. In today's digital and knowledge economy, many companies' book value is small relative to their market value (according to the Ocean Tomo Study of Intangible Asset Market Value, intangible assets are now responsible for over 80% of all business value). Consequently, this value is hidden and needs to be captured using appropriate measurement and qualitative information.

BUSINESS VALUE

- The potential for value creation and growth prospects that drive future earnings and cash flows are based predominantly on intangible assets (non-physical resources and capitals) and ESG factors. These cover a range of areas related to the expected worth of a business reflected by market and intrinsic value (a forward-looking measure of the worth of a business based on a company's strategies and its ability to execute them) and represent sources of competitive advantage and opportunities and risks to value creation.

- Those organizations using a Balanced Scorecard or similar type of performance management approach may already capture a selection of non-financial value drivers that have an impact on their strategic objectives and desired outcomes incorporating tangible and intangible assets. Intangible assets are difficult to replicate and are in limited supply and include customer and supplier relationships, research and development (R&D), intellectual property and innovation (e.g., new product development), people and talent, know-how, data, technology, systems and network effects. Given the value of intangibles is highly contextual, it is important to show external stakeholders how these factors, in their organizational context, support the development of strategic value, competitive position, and long-term success.
- Conventional performance and value drivers such as those related to finance, operations and customers are typically tracked through a variety of metrics and KPIs. For example, an airline will likely track operational revenue drivers including capacity, passenger journeys, passenger yields/average fare per passenger per mile, and load factor. In terms of customers, many businesses dependent on growth will track customer growth, retention, churn, and engagement to reflect customer value linked to recurring revenue. A manufacturing and engineering centric business will track a range of critical R&D and product development value drivers covering capability and performance, such as quality and cost of development, and time to market.

- ESG or sustainability information is increasingly being used in the capital markets as a proxy for trust and reputation, and risk. They provide an indication of material short- and long-term sustainability performance and impacts related to the risks and returns for investors, and therefore supplement their investment and voting decisions. Environmental and social consequences of business activity, and governance issues such as corruption and board effectiveness, represent a wider grouping of factors related to responsible business conduct that also represent opportunities and risks to long-term value creation that can be linked to the performance of intangible assets. Again, using an airline as an example, emissions and fuel efficiency, economic growth, safety, employee morale, training and diversity, and managing data privacy may all be important areas to measure, manage and communicate in relation to value creation.

- ESG metrics are becoming more widely established, particularly as they form the basis of ESG and responsible investing and are shown to drive investment returns. However, ESG strategies and performance need to make economic sense to the company's intrinsic value as well as to its stakeholders. Investors and others are also demanding enhanced relevance, reliability, and comparability of ESG information and disclosures to enable a more accurate assessment of risk. Information on ESG and intangibles is not subject to international standards and rarely subject to assurance, which is an issue of much debate involving IFAC and the accountancy profession (see Enhancing Corporate Reporting).

SOCIETAL VALUE

- Societal value will ultimately be evaluated by positive or negative impacts on stakeholders and society. Positive and negative impacts in relation to relevant stakeholder outcomes provide an indication of societal value of an organization, its business model(s), and its activities. Many relevant outcomes and impacts can be framed by a company's purpose and contribution to the Sustainable Development Goals (SDGs). The SDGs provide a common framework of goals, targets and indicators for governments, business, and others to address systemic, interconnected development challenges such as poverty, inequality, climate change, and peace and justice (a framework for contributing to the SDGs through the value creation process is available here).

- A deeper understanding of corporate impacts and dependencies particularly related to natural capital (e.g., land and water use, emissions, and biodiversity), human capital (e.g., paying a living wage and employee well-being), and social and relationship capital (e.g., supporting communities, customer loyalty and experience) provide the basis of valuing impacts and externalities. Economic valuation allows companies to assess risk and identify opportunities to reduce negative impacts and ideally, over time, evolve their business model(s) to maximize their net positive contribution and make decisions that optimize value creation to key stakeholders.

- Quantifying and monetizing impacts beyond business activities and outputs provides a bridge from value creation to impact. It provides insight into their magnitude, relativity, and interconnectivity, helping to understand and manage trade-offs between the interests of various stakeholders, between short- and long-term consequences, and between selecting one decision option or investment instead of another. Valuation also enables the organization to focus on the continued availability and strength of capitals, resources and relationships.

- Although the valuation and monetization of impacts is not without practical and philosophical challenges, monetization helps boards and management evaluate – through consistent use of the same language – total value across multiple dimensions, compare impacts in a common unit of measurement, and incorporate the impact into existing analysis (net present value and internal rate of return) and reporting (profit and loss, balance sheet, dashboards) tools. Economic assessments and valuations are being used by an increasing number of companies to create integrated impact profit and loss accounting [see Impact Valuation].

IMPACT VALUATION

Economic assessments and valuations are being used by an increasing number of companies to create integrated impact profit and loss accounting. Various initiatives are focused on advancing impact measurement and valuation including the **Value Balancing Alliance**, the **Impact Management Project**, and the **Impact Institute.**

Impacted-Weighted Financial Accounts: The Missing Piece for an Impact Economy, a project by Harvard Business School, is also trying to advance a standardized methodology for valuing impacts. It lists 56 companies utilizing some form of monetary impact valuation of which 86% measure environmental impacts, 50% estimate employment and social impacts, and 20% account for product impacts. An example of monetizing impacts across a value chain is The Crown Estate's (Real Estate Investment) Total Contribution approach – the results are captured in its **Total Contribution** Report (latest version 2017). The report highlights the capitals that the organization relies on to create value and uses impact measurement and economic valuation to highlight the positive and negative flows resulting from its activity and external influences.

Some companies show their impact valuations in a profit and loss statement. The Dutch bank, ABN AMRO N.V, for example, produces an integrated profit and loss statement to quantify and monetize its impacts from non-financial capitals. The process of producing its **Impact Report** (2018) and **Impact Report** (2019) enables the organization to understand trade-offs, increase its total value creation and find the right balance between the needs of its various stakeholders.

Although not all non-financial areas of performance can be easily monetized to provide a quantitative assessment and indication of value, various techniques can be used to provide an economic valuation. For example, BASF's Value-to-Society **methodology** shows how monetary values are assigned to business impacts captured by market prices, abatement costs and benefits in relation to emissions, and costs and benefits arising to society from unpriced externalities resulting from business activities.

OPERATIONALIZING VALUE CREATION

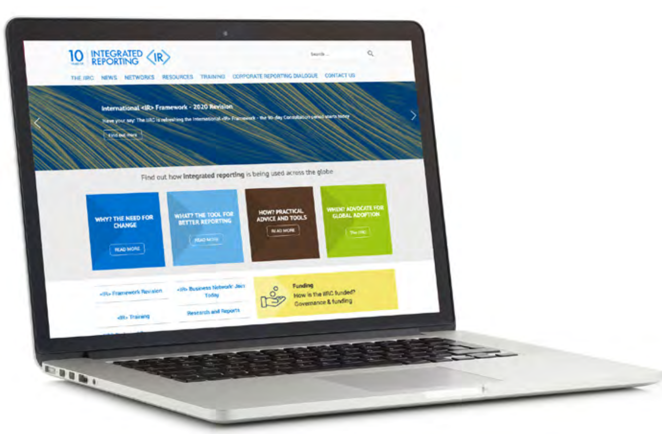
Integrated thinking should result in increased organizational alignment toward long-term value creation. Confidence in making value creating decisions for the short, medium, and long term is based on relevant quality information and analysis. Integrated reporting and communication should provide investors and stakeholders relevant information and insights for them to evaluate business and societal value.

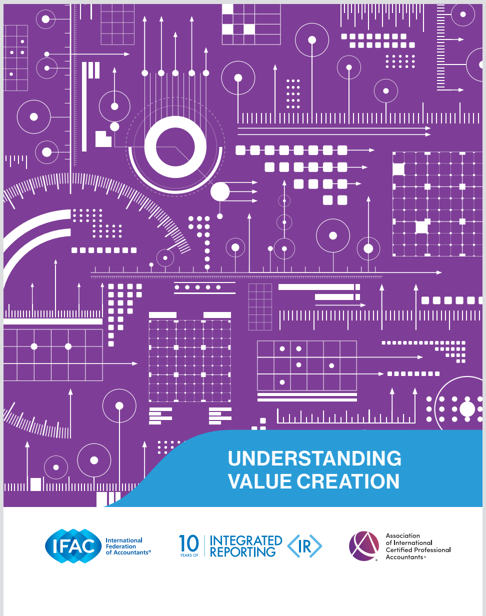
To be effective business partners involves the CFO and finance function delivering actionable information that leads to value creating and preserving decisions. This involves integrating relevant data and analysis about performance and value creation across board, management and operational activities covering a range of areas including

- Achieving a common understanding of the key components of value creation and material drivers and indicators of performance and value across the capitals relevant to purpose, strategy and the business model
- Delivering alignment throughout the organization on key drivers of value creation to ensure consistent application
- Incorporating relevant performance and value information and insights in dialogue and actions related to strategic initiatives, business plans, resource allocation and driver-based planning and forecasting
- Enhancing management reporting and scorecards with relevant KPIs and measures of long-term value creation
- Aligning strategic risk assessment and risk reporting to the value creation process and measurement
- Aligning management and risk reporting to the external integrated reporting process
- Connecting incentives and rewards to value creation objectives and measures of success.

The IIRC's International <IR> Framework refers to six capitals: financial, manufactured, human, intellectual, social and relationship, and natural.

International Integrated Reporting Framework six-capitals approach	Examples of resources and relationships that relate to the capitals
FINANCIAL	Access to financial resources e.g., equity, debt, grants, and performance of financial resources generated within the organization e.g., revenue, margin, return on capital
MANUFACTURED	Operating infrastructure e.g., buildings, equipment and other infrastructure needed by the business e.g., roads and ports
INTELLECTUAL	Organizational knowledge-based intangibles including tacit knowledge, systems and procedures, and intellectual property e.g., patents, copyrights, rights and licenses
HUMAN	Governance and leadership, workforce development including people's competencies, capabilities and experience, and performance and engagement
NATURAL	All renewable and non-renewable environmental resources that provide goods and services, including access to natural resources, impact of products, services and operations and suppliers
SOCIAL AND RELATIONSHIP	The relationships with key stakeholders, partners and networks including customers (e.g., current and target customer and end-user base, access and channels, engagement and fulfillment), partners/collaborators (e.g., government, regulators, suppliers), brand and reputation including social license to operate





For more details on understanding value creation, visit this related report.

International Federation of Accountants
529 Fifth Avenue
New York, NY 10017
USA
T +1 212 286 9344
www.ifac.org

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