

CGMA REPORT

BUILDING  
WORLD-CLASS  
BUSINESSES

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For the long-term

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# KEY FINDINGS

1. Events such as the global financial crisis and the growing challenge of environmental sustainability have brought new urgency to the age-old debate of how business fits into society. Modern communications and globalisation are also creating greater complexity – simply formulating the right questions is difficult; finding solutions – the “new normal” may be near impossible.
2. One key theme permeates much of the discussion: a condemnation of short-termism and the promotion of long-term thinking. This is, in part, responsible for the retreat from short-term shareholder value as the dominant business philosophy and increasing interest in alternative models.
3. Executives face two daunting challenges as they embrace the value of long-term thinking and strive to create sustainable businesses. First, the genuine need for short-term stewardship can distract managers from their long-term vision. Second, defining the long term and embedding it into today’s operations are more complicated tasks than they may seem at first glance. The key is to think creatively about the challenge of juggling short and long-term goals.
4. A long-term vision is more likely to align with the public interest, but with two caveats. The first is that the long-term mission must be based on sound moral and ethical principles. The second is that it must be executed pragmatically, assuring that short-term actions support the long-term goals.
5. Creating long-term value does not mean that short-term needs can be ignored. However, managers need to recognise short-term pressures that do not contribute to the long-term vision. These include poorly defined performance targets and the pressure to “follow the herd”.
6. The relevant time horizon can be difficult to pin down and is influenced by factors such as industry characteristics. Much of the confusion can be cleared when companies distinguish between a long-term perspective and a long-term planning horizon.
7. Managers need to create a meeting point where long and short-term needs connect. If immediate goals clash with long-term aspirations, the incongruence is a symptom of an unhealthy company. Traditional strategic planning creates a useful hierarchy of ideas to support an organisation’s thinking from high-level purpose to five-to-ten year strategic goals through to short-term operational actions. However, the past offers little guidance to the baseline assumptions on which companies now need to formulate their future.

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8. Global challenges including climate change, population growth and loss of biodiversity, mean that companies must incorporate a much broader range of issues into their planning than ever before. Governments and regulators have a key role to play in creating the carrots and sticks which will ensure that business incorporates such impacts into their planning. But companies that are able to work with future uncertainty and to translate this into short-term action can have a major competitive advantage.
  9. Management accounting tools such as the balanced scorecard can help highlight the areas that companies must address to maintain sustainable business models and to manage the link between the short and long term. Management accountants have a key role to play in providing and analysing data around the key drivers of long-term business performance and in designing performance management systems that encourage the desired behaviours.
  10. Companies should focus on the following aspects of their business models to ensure that their short-term actions support a long-term future: attracting and retaining customers, a motivated and skilled workforce, durability of the supply chain, innovation and cost leadership. At the heart of these considerations is the core business model which asks the basic question: *How do we make money?*
  11. The CGMA Workshop section provides some initial questions to help translate the high-level messages of the report into action.

“The recent financial crisis and issues such as climate change, food security and poverty mean that business as usual is no longer an option. Leading companies are asking themselves what part they can play in ensuring equitable and sustainable growth for generations to come. A critical requirement for this is to shift the organisational focus to the long term. This report makes a helpful contribution to understanding how this can be done.”

– Paul Polman, Chief Executive Officer, Unilever

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# INTRODUCTION

Events over the past few years have brought new urgency to the age-old debate of how business fits into society. Companies are being chastised from all directions for focusing on their own self interest and that of their shareholders and told they must act in the public interest.

Multiple stakeholders offer conflicting ideas of how best to organise and govern activities that generate wealth. The agency problem, arising when ownership and control of a company are separated, has come under increased scrutiny. And, of course, the market's structural failures and how to fix them are recurrent themes for conferences, television talk shows, blogs and newspapers.

On its own, the global financial crisis would have been enough to provoke serious soul-searching about the role business should play in society. But even before toxic assets and Lehman Brothers' downfall, corporate scandals at the start of this century – notably Enron and WorldCom – signaled severe faults in the prevailing corporate governance and philosophy.

But while the debate might not be new, additional facets have created increased complexity. Modern communications, as one example, have accelerated exponentially the spread of news and rumors and contributed to today's volatile and rapid share trading. Globalisation is also changing the rules of the game. The dominant western model for public companies has been challenged by the emergence of world-class companies from developing markets that have different views on governance and structure, as well as the ascendant of powerful new investors such as sovereign wealth funds. And the refocus on global sustainability has shattered long-held assumptions on corporate value.

Just formulating the appropriate questions in such a complex environment is difficult; finding solutions – the “new normal,” as some call it – may be near impossible.

In the midst of all this chaos, one theme permeates much of the discussion: a condemnation of short-termism and the promotion of long-term thinking. In a nutshell, short-termism is a fixation by company managers and investors on immediate gains with little if any consideration for longer term benefits or harm. The attitude has been blamed for some of the worst excesses of the global financial crisis and an excess of “public bads,” as green economists see environmental damage and other negative externalities to society that aren't represented in the financial statements.

Short-term thinking, for example, is blamed in part for the takeover of British iconic chocolate manufacturer Cadbury by Kraft, the US food giant. In early 2010, after a four-month battle, Kraft completed a US\$19.4 billion hostile takeover of Cadbury. During the takeover battle, the share of stock in Cadbury owned by short-term investors including hedge funds went from 5% to 31%, suggesting that the only open question was the final bid price. The deal was heavily criticised in the UK as an example of a venerable company that had fallen victim to impersonal short-term market forces.

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Sir Roger Carr, Chairman of Cadbury during the merger battle, lamented, “At the end of the day, there were simply not enough shareholders prepared to take a long-term view of Cadbury and prepared to forego short-term gain for longer-term prosperity. Individuals controlling shares which they had owned for only a few days or weeks determined the destiny of a company that had been built over almost 200 years.”

Against this background, companies and shareholders are being exhorted to think long-term. Abandoning short-termism for the longer horizon, it seems, would cure all ills and transform companies everywhere into forces for good.

But shifting gears and acting suddenly in the long-term interest is not as straightforward as might be suggested and raises many questions. What are the challenges of implementing a long-term focus and how does it look in practice? What is needed to link directly long-term aspirations to a company’s day-to-day operations and success? And would a long-term view really mean that a company’s relatively narrow interests would converge with the wider public interest? Many companies are exploring these questions, and some such as Unilever, IBM, Tata, and Ford have shown some immediate progress.

This report identifies some of the factors complicating the debate on the role of the company in society. We focus particularly on the changing models of ownership and differing time horizons and on how these have interacted in some cases to produce undesirable consequences.

We then consider the argument for a long-term approach, identifying some of the difficulties of defining and delineating the long-term. Of particular importance is how to manage the interplay between

short and long-term thinking. We look at the role of government and regulation in fine-tuning long-term incentives so that they fall within a reasonable timescale of most companies. And we consider whether long-term approaches by individual companies best serve the public interest.

Next we examine the practical considerations of pushing forward a long-term view. Disoriented by the current maelstrom, it is easy for managers to lose sight of the perennial principles of good organisational practice.

These proven principles give companies the best chance of success in any situation. Even as managers seek to clarify the over-arching purpose and structure of business, these practical measures for navigating through the confusion manages the present without compromising the future.

We conclude that a world-class, sustainable business must focus on a basic set of priorities – a clear strategy, cost leadership, a durable supply chain, a motivated staff, satisfied customers and innovation. When successful, this approach can create enduring corporate value and organisations that prosper not just for months and years, but for decades. We suggest ways of bringing this approach to life by creating a framework for organisations to use and adapt to meet their specific needs. At the end of the report, we offer the CGMA Workshop, a section which will help translate the high-level messages into practical tools and questions that can move any organisation forward.

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## CURRENT ISSUES

Until recently, the debate about appropriate ownership models and the role of business in society has been generally confined to college lecture halls, board rooms and perhaps, the business columns of selected media.

Indeed, periodic corporate scandals have momentarily raised the profile of the discussion, but more often than not these failures have been attributed to greed rather than some underlying crack in the system. The wide-ranging suffering brought by the financial crisis has changed the discussion.

### A changing climate for listed companies

The so-called Anglo-Saxon model of corporate ownership, prevalent in the UK and US, has been under increasing pressure in recent years. The model features dispersed ownership of shares and dominance by institutional investors such as pension funds. For decades, it has been considered the most effective ownership structure for public companies, even though it exacerbates the agency problem (a sharp separation between ownership and management). The key advantage of the model is access to global capital.

The model served the market and businesses well. For example, in the 1980s in the United Kingdom, shareholders like pension funds and insurance companies were the dominant owners of many major public corporations and largely represented the interests of all shareholders. In general, they took a long-term view of their investments. In this environment, there was a common interest among shareholders, corporate managers and board members. Shareholder activism focused on ensuring a strong board of directors was in place that could exercise judgment independent of the management.

But over the past few decades, the smooth operations of the Anglo-Saxon model have been attacked by some. “Shareholders, in the Adam Smith model, take an active interest in the joint stock company,” said Paul Abberley, CEO of Aviva Investors London. “You could argue [that interest] was there in the nineteenth century, but if it was, it was lost in the last 30 years.”

An explosion of new players – hedge funds, sovereign investment funds, private equity funds and others – has broken down the premise of commonality. Ira Millstein, an expert on corporate governance at Yale University, said in 2008 that this change “has created for corporations and their boards a ‘zoo’ of owners with different stripes, teeth, sensors, claws, vision, strength, will, and attitudes.” The agency problem is no longer confined to owners and managers, but stretches along the entire investment chain, from the original providers of capital to the ultimate users, creating a complex web of principal and agent relationships.

Gazing at this menagerie, in which values are diffused and often conflicting, managers find it difficult, if not impossible, to identify and understand the shareholder interests they are meant to serve. This is uncharted territory and has awakened images of “ownerless corporations,” where the diversity of shareholders means there is no dominant or powerful voice among the owners to hold the board to account.

Investment techniques and instruments have also proliferated rapidly in recent years. High-frequency trading, short selling, share lending, hedging and other opaque options have helped decouple investors’ title ownership and their true economic interest. Off-market trading, for example, is a recent phenomenon, giving players the chance to buy and sell shares even when exchanges are closed. What looks on paper to be a large owner of a company may only be a renter with a significantly different agenda than that of the longer-term share owner. Hedge funds have taken the brunt of the criticism for this shift, and CEOs such as Paul Polman at Unilever, have made it clear that it is not their job to keep the hedge funds happy, saying “They are not people who are there in the long-term interests of the company.”



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## Rise and fall of shareholder value

The underlying shifts in ownership and investment structures have promoted the west's embrace of shareholder value – in particular the fixation on short-term results that it encourages. Shareholder value has underpinned management thinking in developed markets for almost three decades.

A sharp focus on concepts of shareholder value and the consequent emphasis on short-term results have, at best, outlived their usefulness. And the problem is not confined to corporate head offices. The mantra of maximising shareholder value has created a destructive cycle, with shareholders quick to sell and reinvest elsewhere, outside analysts focused on stock prices as the key metric of corporate health, and top executives (urged forward by imbalanced incentive packages) anxious to guide share prices higher.

Shareholder value has a noble lineage. Its antecedents can be traced at least as far back as 1776, when Adam Smith wrote in *The Wealth of Nations*, “It is not from the benevolence of the butcher, the brewer, or the baker, that we can expect our dinner, but from their regard to their own interest.” More recently, profit maximisation as the guiding star for companies was given intellectual credibility in a 1970 *New York Times* article, in which Milton Friedman wrote famously that the “one and only one social responsibility of business’ is to increase profits”. Anything less, the conservative economist argued, was “pure and unadulterated socialism.”

In essence, the notion of shareholder value suggests that the ultimate success of a company should be judged by how well it enriches its shareholders, either through dividend payments or share price increases. With the stock market as the judge and jury, strategic horizons shrank to a myopic fixation on short-term results. Shareholders were quick to sell when companies missed their own profit targets. Results were weighed heavily against expectations. And, executives, often nurturing bonus packages linked to meeting yearly targets, adjusted their strategies accordingly.

The idea gained currency following a 1981 speech by Jack Welch, then the new CEO of GE and later dubbed “the father of the ‘shareholder value’ movement” by *The Financial Times*. The speech described Welch’s mission to increase profits, primarily by cutting costs and discarding underperforming businesses. As a

result, Welch said, GE would be “the locomotive pulling the GNP, not the caboose following it.”

But almost three decades later, just as famously, Welch abandoned this child. “On the face of it, shareholder value is the dumbest idea in the world,” he said in 2009. “Shareholder value is a result, not a strategy... your main constituencies are your employees, your customers, and your products.”

Polman at Unilever is among a growing cadre of top executives turning away from shareholder value. Among his early acts was to stop offering earnings guidance to investors, “I do not work for the shareholder, to be honest; I work for the consumer, the customer,” he said. “I’m not driven and I don’t drive this business model by driving shareholder value. I drive this business model by focusing on the consumer and customer in a responsible way, and I know that shareholder value can come.”

The retreat from shareholder value was hastened by the global financial crisis. Many critics blame an excessive focus on share price, especially in the financial services sector, for the kinds of risky strategies that created a debilitating amount of toxic assets, brought down Lehman Brothers and others, and sent most of the world into recession.

## The stakeholder perspective

As the shine of shareholder value has dulled, a new emphasis centred on the perspective of multiple stakeholders has emerged. “Intellectually, this is an exciting time,” wrote Stefan Stern, a *Financial Times* columnist. “Academics and business thinkers are being forced to return to first principles, question base assumptions, and consider whether trusted models have led them astray.”

Reporting on the events at the World Economic Forum in Davos, Switzerland, in 2011, Anthony Hilton, a columnist at the *Evening Standard* noted, “The ethical and moral question for Davos is to explore how managers can genuinely reconcile the competing and potentially conflicting demands of multiple stakeholders in a way which creates a sustainable business... the current benchmark for success, shareholder value, has been found to promote all sorts of division which the public and politicians no longer find acceptable, from opportunistic foreign takeovers of British businesses to the collapse of corporate pension schemes to the questionable profits used to justify bankers’ bonuses.”

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Such attitudes fit well with the teachings of Peter Drucker, the widely respected management writer. “Business enterprises ... are organs of society,” he wrote in *The Essential Drucker*. “They do not exist for their own sake, but to fulfil a specific social purpose and to satisfy a specific need of society, a community, or individuals. They are not ends in themselves, but means.” He acknowledged that profit and profitability are essential for any business, but warned, “The concept of profit maximisation is, in fact, meaningless.”

Managers moving beyond the stale precepts of shareholder value must take on such attitudes. Mentally, this requires understanding a wider range of stakeholders: shareholders, undoubtedly, but also employees, customers, business partners, communities in which the company operates, and even, in terms of pollution, climate change, biodiversity and other externalities of business, the planet itself. An initiative launched in November 2012 demonstrates the growth in this thinking. The Economics of Ecosystems and Biodiversity (TEEB) for Business Coalition is a global, multi stakeholder platform for supporting the development of methods for natural and social capital valuation in business. A range of stakeholders are involved – from accountancy bodies such as CIMA to the World Business Council for Sustainable Development.

Decisions cannot be made based solely on the benefits offered to one group of stakeholders. The duties of directors, for example, relate to the long-term success of the company for the ultimate benefit of shareholders. This recognises that companies will not succeed in the long-term if the directors do not take account of other stakeholders. There will likely be times, for example, when some slice of profitability should be sacrificed in the short-term to maintain staff motivation, to help a reliable supplier, or to protect a neighbourhood beyond the legal mandates or public relations impact.

However, as John Maynard Keynes wrote almost a century ago, “In the long run we are all dead.” Managers and investors pressing for a shift to long-term thinking face a challenge in defining how long exactly the long-term is.

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# WHAT IS THE 'RIGHT' TIME HORIZON FOR BUSINESS?

No one starts a business to fail, and fortunately few purposely run a business to ruin. Founders, managers, board members and most other stakeholders usually want their companies to prosper indefinitely, and many of today's corporate giants take pride in their longevity.

The recent focus on short-term strategies and shareholder value has blurred the view of the distant horizon, but has not diminished the general desire to reach it.

But executives face two daunting challenges as they rediscover the value of long-term thinking and strive to create sustainable companies. First, the genuine need for short-term stewardship can distract managers, even those with the best intentions, from their long-term vision. Second, defining the long term and embedding it into today's operations are more complicated than they may seem at first glance.

## Thought starter: is the public interest satisfied?

Do the actions of companies with long-term strategies inevitably converge on the public interest? Unfortunately, there is no guarantee.

Even the largest companies do not reach into every part of the world, and it's often the poorest populations that are the last to feel the benefits of global economic growth. In addition, even companies with the best intentions may simply fail to deliver.

But long-term vision, with two caveats, is more likely to align with the public interest than the model that helped trigger the global crisis. The first caveat, obviously, is that the long-term mission must be based on sound moral and ethical principles. The second is that it must be executed pragmatically, assuring short-term actions support the long-term goals.

## Managing short-term needs

Creating long-term value does not negate the need to tend to the immediate needs of a company. When driving a car, it's not enough to know your destination. You must also be aware of the cars around you, the course of the road, your fuel level and other pressing matters. In the same way, companies must manoeuvre through today's market to make it to the long-term horizon. However, managers must also do a better job at recognising the short-term pressures that needlessly interfere with their longer-term goals.

The most visible source of short-term pressure is the desire to please the stock market. Regular earnings guidance and efforts to meet these public targets can have a negative effect on long-term value in many companies. Reporting from a survey of more than 400 executives in 2004, three US economists found "an astonishing 78% admit that they would sacrifice a small, moderate or large amount of value to achieve a smoother earnings path." Based on a separate survey a few years later, McKinsey & Company noted, "Providing quarterly guidance has real costs, chief among them the time senior management must spend preparing the reports and an excessive focus on short-term results."

But other corporate elements that encourage short-term thinking are more subtle. Performance targets for business units and individuals that highlight easily measured and relatively volatile metrics can also support behaviours counter to a company's long-term vision. For example, management bonuses may be tied too closely to achieving quarterly or annual sales targets at the expense of sustained customer relationships.

The herd mentality also contributes to placing more urgency on short-term pressures than necessary. Mimicking the actions of competing companies – whether by dabbling in exotic financial instruments, continuing with energy-intensive technologies or following some other industry trend – is often an easier decision than breaking away. It offers a modicum of strategic cover and lessens the risk of lagging behind (while also hindering a company’s ability to pull ahead).

Talking about Citigroup’s leveraged lending practices, then-CEO Charles “Chuck” Prince said infamously in 2007, “When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing.” The comment dogged the financial executive for years, and in 2010 he explained, “My belief then and my belief now is that one firm in this business cannot unilaterally withdraw from the business and maintain its ability to conduct business in the future.”

A handful of companies are finding ways to side step some of the distractions of the short-term and break from the pack. Unilever, Ford, Berkshire Hathaway, and AT&T, among others, have stopped publishing quarterly guidance, for example. The key is to identify ways to operate a company profitably in the short-term without losing sight of long-term goals.

“Sometimes, apparent tension between short and long-term goals is the result of not thinking creatively enough about the challenge,” said Thomas Lingard, Global External Affairs Director for Unilever. “You have to do both. It’s not about saying the short-term doesn’t matter.”

Investor sentiment is also beginning to shift. “We sense a real groundswell change in the way shareholders want companies to behave,” said Abberley at Aviva Investors London, “and I don’t view that as being entirely altruistic either. The industry should not be waiting to be called to account.”

## CASE STUDY

### SHIFTING PERFORMANCE TARGETS TO THE LONG-TERM

Selling new cars is a volume game, right? The more shiny saloons that leave the showroom, the better for the dealership.

A close look at Van den Udenhout (VdU), a dealership with outlets throughout the Netherlands, showed such “common sense” can destroy value when reinforced by inappropriate performance targets. Like most car dealerships, VdU was organised around profit centres: sales, service, finance and insurance, service, and leasing. Profit centre managers were given ambitious monthly targets, generally linked to transactions, such as the number of cars sold, and, not surprisingly, managers focused on transactions.

Customer relationships, however, are far more important to new car dealerships than individual transactions. Selling cars is not particularly profitable, and incidental customers – those who buy a car and are never seen again – generated hardly any profit. Financial services, maintenance,

and body work have a much greater impact on the bottom line, yet the performance leaned heavily on sales volume and paid little heed to building long-lasting customer relations and expanding the network of loyal customers.

To change the attitudes and behaviours of sales staff and managers, VdU had to redefine how it measured performance, in essence shifting from a short-term focus to a long-term one. It had to go from an emphasis on profit centres and transactions to one on profitability throughout the customer life cycle. The change required that the company gather new streams of data and inaugurate a different set of key performance indicators.

(More details of this case can be found in *Using management accounting to lengthen the time frame of managers*, E. Pieter Jansen, University of Groningen, Research Executive Summary series Volume 6, Issue 11, CIMA, 2010.)

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## Defining the long-term

The relevant time horizon for companies shifting away from a fixation on the short-term is difficult to pin down. Shareholders offer little help. But there is general agreement that holding periods have become shorter due to lower transaction costs and technology.

Company statements and business literature offer a full range of potential horizons, from one year for small enterprises to 100 years (Unigen Pharmaceuticals, a US/South Korean genetics firm, said in 2006 they had developed a 100-year business plan). Industries that depend on long-lasting, capital-intensive assets, such as energy and steel, often look 30 or 40 years ahead when making investment decisions, and for those that need significant time for product development, such as branded pharmaceuticals, the planning horizon is generally about 15 years ahead. But when fast-paced changes in tastes and technology are factors, such as consumer electronics or fashion, anything beyond a two-year horizon could be meaningless.

Without doubt, the characteristics of an industry and individual companies have an effect on how managers see the future. Size, potential environment impact, the pace of change, and investment timelines, among others, are all relevant.

Yet much confusion can be cleared when companies actively distinguish between a long-term perspective and a long-term planning horizon. The perspective provides a vision of how the company imagines the world, ideally, 20, 50, even 100 years into the future. It provides a guiding star that directs the company, offers a sense of purpose, and provides an argument for or against today's decisions. The planning horizon must be more practical. It should offer targets that are far enough into the future that creativity isn't stifled because of time limitations, yet near enough to the present that changes need to begin immediately for the targets to be reached.

"It's very easy to write a vision statement for something very far ahead. You get a type of utopian outlook, without any pressure to explain how you will get there," said Lingard at Unilever. "If you are serious about changing the way you do things, the way you work in the short-term, then ten years provides enough scope to think radically, but not so much that it's abstract."

Beyond the ten-year horizon, uncertainty plays an even bigger and more unwieldy role. The "possible" futures expand exponentially to near infinite permutations. Such long-range vision becomes the realm of futurology, where best guesses about changes in the environment, market, industry, economy, technology and countless other factors can fall wide of the mark. At best, managers can only imagine the possibilities, work toward the ideal, and brace themselves for the black swans or the unknown unknowns.

## Where short- and long-term needs meet

When managers try to steward their organisations toward a long-term vision, the crux of the challenge is in creating a meeting point where long and short-term needs connect. If immediate goals clash with long-term aspirations, the incongruence is a clear symptom of an unhealthy company. If achieving quarterly volume sales targets is a company priority, for example, this can be quickly achieved by offering deals to buyers, but the long-term damage of devaluing a product or service can be tremendous.

A return to basics is the first step toward managing this intersection. Traditional strategic planning creates a useful hierarchy of ideas to support an organisation's thinking. The cascading philosophy begins with high-level statements of mission, vision or purpose that articulate a broad direction, overarching values, and aspirations (the long-term perspective). Next, long-term strategic planning takes this philosophy and translates into general goals, usually over five to ten years (the long-term planning horizon). Short-term operational planning refines these goals further, integrating them into very specific, detailed action with concrete targets for the next year or so.

But when the tail wags the dog, when short-term decisions are made with little regard to long-term goals, the hierarchy breaks down. US investor Warren Buffet cautioned, "It takes 20 years to build a reputation and five minutes to ruin it. If you think about that, you'll do things differently."

The past, unfortunately, offers little guidance. Of course, many great companies have shown a remarkable ability to adapt to change, whether in technology, tastes, or the competitive landscape, and

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the best have put considerable resources towards understanding the threats and opportunities the future may present. But there were always certain baseline assumptions such as natural resources being reasonably abundant and, literally, the environment remaining stable.

These assumptions are no longer valid. Resources from oil to water cannot be taken for granted and global challenges including climate change, pollution, population growth, and the loss of biodiversity have a direct impact on every business model, whether a small microbrewery securing clean water to a multinational potato chip producer contemplating a world with scarcer potatoes. As a result, companies must incorporate a much broader range of issues into their planning, creating increased complexity and uncertainty. Henry Ford in 1911 did not need to worry about a world without petrol; his great-grandson William Ford Jr. in 2011 must.

Being able to work with future uncertainty and translate this into short-term action can be a major competitive advantage. Along with aligning the two horizons, communication and commitment are critical factors for success.

Lingard at Unilever offered an example. Ice cream cabinets – those ice boxes at corner stores featuring Magnums, Cornettos, and other treats – traditionally used hydrofluorocarbons (HFCs) as refrigerants. The problem was that these refrigerants had a very bad impact on climate change as the gases can be a thousand times worse than carbon dioxide for global warming. Unilever wanted to shift to cabinets that ran on hydrocarbons, which had less environment impact, but which were not commercially available. Refrigerator suppliers may have been willing to develop better cabinets, but the costs could have been prohibitively high. When the company publically committed to changing its two million ice cream cabinets globally, suppliers were assured the scale needed to finance development and keep unit costs down.

“People have to think about the signals that they send to the supplier base,” Lingard said. “Too many people give up. They abandon innovation opportunities based on the first numbers they get from their suppliers.”

Most companies do not have such unilateral power to shift the market. But by working openly with customers, suppliers, regulators, and – within the bounds of anti-trust laws – even competitors, they can exercise surprising influence on the course of industries.

## Thought starter: the role of government and regulators

As businesses and industries transition to a new way of thinking, governments and regulators may need to step in to assure that early movers are not disadvantaged.

Initial moves in this direction include measures taken to impose carbon pricing on organisations that emit greenhouse gases. But many other externalities that generally aren't represented in profit-and-loss statements must also be addressed. Companies that contribute to the depletion of natural resources, such as fish stocks or forests, must be required by authorities to account for these costs through mandated pricing mechanisms or some other device.

In early 2011 the global sportswear brand, PUMA, became the first major multinational to issue an environmental profit and loss account. It was the first ever attempt to measure, value and report the environmental externalities caused by a major corporation and its entire supply chain. PUMA focused on greenhouse gas emissions and water consumption and put a monetary value on their environmental impact. They valued their environmental impact at 94.4 million euros. To put this into context, PUMA's profits that year were 202 million euros.

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## Thought starter: key developments in value reporting

Integrated reporting (<IR>) is a new approach to corporate reporting which is rapidly gaining international recognition. <IR> demonstrates how organisations really create value:

- It is a concise communication of an organisation's strategy, governance and performance.
- It demonstrates the links between an organisation's financial performance and its wider social, environmental and economic context.
- It shows how organisations create value over the short, medium and long-term.

Integrated reporting gives a 'dashboard' view of an organisation's activities and performance in this broader context. This will:

- Enable more effective decision making at board level.
- Improve the information available to investors.

- Encourage more integrated thinking and business practices.

All of this ultimately helps build more resilient and successful businesses.

This initiative is being driven by the International Integrated Reporting Council (IIRC). In April 2013 the IIRC released a consultation paper of the international <IR> framework – the world's first global <IR> framework. Visit the IIRC website ([iirc.org](http://iirc.org)) to find out more.

A series of background papers support the development of the consultation draft. The Business Model paper was authored by CIMA, PWC, IFAC and Materiality paper, by the AICPA, for the IIRC. The papers can also be found on the IIRC website.

# PRACTICALITIES – THE BASICS BEHIND VALUE

We believe a world-class, sustainable business must focus on a basic set of priorities:

- a strategy that effectively connects short-term actions with long-term aspirations
- cost leadership
- durability of the supply chain
- a motivated and skilled workforce
- attracting and retaining customers
- the ability to innovate.

When successful, this approach can create enduring corporate value and organisations that prosper not just for years, but for decades.

However, getting these fundamentals right is no guarantee of corporate success and longevity. Nothing is. Unforeseen factors such as sudden shifts in consumer taste, new technologies, and countless others can undermine even the best businesses. This is why an organisation also needs to understand how the **external environment** and its associated **risks and opportunities** impact its long-term

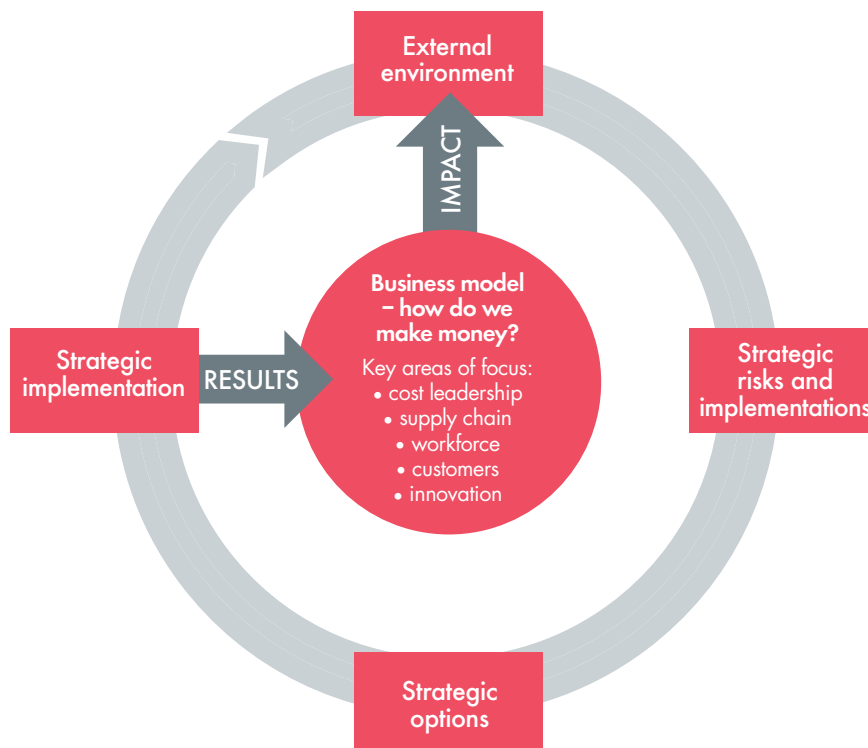
vision. It should generate and evaluate a range of **strategic options**, selecting the most promising ones based on its concept of vision and purpose, then move through to **effective implementation**.

The entire process must be dynamic, with managers and executives constantly questioning whether the strategy is relevant and best fulfils the company's stated vision and purpose. Managing the interface between long and short-term the tradeoffs between the vision of the future and the immediate needs of the company, is a critical challenge. Tools such as the balanced scorecard serve to translate strategy into action and ensure congruence between short-term actions and long-term goals.

## 1. Cost leadership

Cost leadership requires non-stop efforts to increase efficiency and reduce the cost of resources used by the business. Lowering costs allows organisations to generate higher margins at prices that are more competitive. Beyond the immediate corporate advantages, cost leadership also promotes decreased use of the world's finite resources while maintaining production levels.

FIGURE 1





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## CASE STUDY

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### COST LEADERSHIP – INTERFACE FLOR

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There are many examples of organisations which focused on cost leadership as a source of competitive advantage, for example low-cost airlines and retailers such as Walmart which has consistently sought to obtain the best possible prices from its suppliers. Strategic purchasing, outsourcing and plain cost-cutting are all well-used means of achieving improvements in the bottom line.

InterfaceFLOR represents an interesting example of an organisation that is reinventing ways of doing business that minimises the impact on the environment while enhancing shareholder value. InterfaceFLOR is a worldwide leader in the manufacture of modular flooring and has a mission to eliminate any negative impact the company has on the environment by 2020. This involves a three-pronged approach including cultural change, but it is the other two elements which are of most interest here. Not only is InterfaceFLOR seeking to reduce its footprint through reduced energy, waste and water usage, for example, but it is going further by redesigning products and processes in such a way that provide extra momentum to this effort. Some products such as the “Flatworks” range use 50% less yarn while end of life technologies mean that today’s products form raw materials and resources for tomorrow’s products. Not surprising therefore that in 2012 the company achieved some impressive results since 1996.

For example:

- total energy consumption per unit of output down by 39%
- total energy from renewable sources was 36%
- reduction in waste from manufacturing to landfill down by 84%
- percentage of recycled or bio-based raw materials used to manufacture products up from 1% to 49%
- cumulative avoided costs from waste elimination activities of US\$488 million (since 1995).

As Lindsey Parnell, President and CEO, InterfaceFLOR Europe, Middle East, Africa and India, has pointed out, “Our continued progress proves that sustainability is not only good for the environment but also for the bottom line,” said Parnell. “Putting sustainability at the heart of our business has paid dividends; costs are down, our people are galvanised around a common purpose and our products are better than ever as sustainability provides an infinite source of innovation.”

Extensive information on InterfaceFLOR’s efforts in this area can be found on [interfaceflor.com](http://interfaceflor.com).

## 2. Durable supply chain

For a business to succeed in the long-term, it needs to secure the supply of resources used to produce its goods or services. A durable supply chain is an inescapable component of a successful business model. An example of how ensuring a supply chain and responsible business strategy coincide, would be offering suppliers of basic resources fair wages.

Supply chain durability needs to be balanced against the goal to achieve cost leadership. For example, excessive pressure on suppliers to offer low prices could impact on their ability to pay fair wages, so having a longer-term adverse effect on supply chain durability.

## CASE STUDY

### DURABLE SUPPLY CHAIN – LI & FUNG

Li & Fung, a global trading group based in Hong Kong, has created significant competitive advantages through innovation and skilled supply management. The 100 year-old group has overcome internal silos to coordinate a complex network of suppliers that span more than 40 countries, creating an organisation with almost 28,000 employees and annual revenues of US\$20 billion, primarily from its sourcing operations.

Group Chairman Victor Fung said in 2008, "Competition is no longer between companies but between supply chains." To fulfil an order for shirts, for example, the yarn might be sourced from South Korea, the dyeing and weaving from Taiwan, and the final production completed at several mills in Thailand. "At each stage we will consider the best place to produce the component we need. The end-product, therefore, becomes a truly globalised one," he said.

Technology has enabled such complex supply changes, but the chain is strengthened by a holistic view of the entire process and transparency for all partners. For example, a manufacturer that might want to hold down costs by avoiding overtime must take into account the impact on delivery times and other suppliers. Suppliers are informed of shipment dates and other key aspects of an order, allowing them to optimise their role in fulfilment, discover potential cross-selling opportunities, and even offer alternatives.

"It is this kind of intimate knowledge of suppliers, and our ability to co-ordinate and influence them that put us in a position where we can stitch together a network of suppliers to satisfy orders from anywhere in the world," Fung said.

The group has developed seven principles of supply chain management:

- Be customer-centric and market-driven.
- Focus on one's core competency and outsource non-core activities.
- Develop a close, risk- and profit-sharing relationship with partners.
- Design, implement, evaluate and continuously improve the work flow, physical flow, information flow, and cash flow in the supply chain.
- Adopt information technology to optimise the operation of the supply chain.
- Shorten production lead time and delivery cycles.
- Lower costs in sourcing, warehousing and transportation.

### 3. A motivated and skilled workforce

A successful business needs a committed, ethical and motivated workforce. Promoting an ethos of “doing the right thing, even when no one is looking” will help both the business and the wider community. Ethical behaviour reduces the threat of fraud within an organisation and enhances the reputation of an organisation among its wider stakeholder group.

## CASE STUDY

### A MOTIVATED AND SKILLED WORKFORCE – TESCO

Tesco is one of the top retailers in the world with over 6,000 stores and 520,000 people in 13 countries, including the UK, Ireland, Poland, China, Malaysia and the US. It has long been characterised by its strategic approach to building and maintaining a skilled and committed workforce. Tesco’s “Every Little Helps” strategy is reinforced by its two core values of “No-one tries harder for customers” and “We treat people how we like to be treated”. Tesco’s approach is that if it looks after its people and treats them with trust and respect, staff will do their best for customers. This will in due course have positive impacts on sales and profit. It is not surprising therefore that so many Tesco people stay with the company for 25 years or more. It is particularly noteworthy that Tesco’s chief executives have been recruited from inside the company – strong evidence of Tesco’s commitment to growing its talent base.

“We’ve trained ourselves to be obsessive about training”, says Tesco, which prides itself on the significant numbers of staff on development programmes – 7,000 at any one time and 80% of management roles are filled by existing team members.

The Tesco Academy has been established to support the training and development of employees in leadership, management and technical skills. A training academy was opened in South Korea to ensure that people development in Asia keeps pace with the rapidly growing business while the UK-based European Academy provides a hub for the managers and directors from across the world.

Tesco brings 100 of its most senior leaders together on an annual basis to share strategy, develop leadership skills and build their network.

A key distinctive feature of Tesco’s approach is that it devotes considerable effort to ensuring that all staff can see how their actions affect the bigger picture. Its primary tool for doing this is the Tesco Steering Wheel – perhaps better known to the outside world as the balanced scorecard. Key performance indicators relate to five key aspects of the business – customer, community, operations, people and finance and help to ensure that Tesco manages the business in a balanced way with due regard to the needs of all stakeholders. In this way, Tesco tracks people information just as closely as financial results. Its particular areas of focus relating to people are:

- to provide an opportunity to get on
- to provide interesting jobs
- competent management (“a manager who helps me”)
- to treat people with respect.

In this way, Tesco’s approach to people management is closely integrated with its overall strategy and values and in turn, represents a powerful source of long-term competitive advantage.

Sources: [www.tescopl.com](http://www.tescopl.com) and [www.tesco-careers.com](http://www.tesco-careers.com)

#### 4. Attracting and retaining customers

No business can survive without customers who require its product or service. To succeed, businesses must often anticipate their customers' needs, even before they are aware of them themselves. Increasingly, customers are looking for socially responsible companies to supply their goods and

services and seek to understand the origins of the materials that go into their goods or are used to deliver services. Among many examples, a growing proportion of consumers want assurances that no child labour was used in the manufacture of clothing.

## CASE STUDY

### CUSTOMER FOCUS – SAB MILLER

SABMiller, the world's second largest beer maker, produces more than 286 million hectolitres of lager a year. Its goal? "Making more beer, but using less water."

A recent Bridgestone survey of U.S. consumers in 20 cities found that the majority hold organisations accountable for the environmental sustainability of their products and processes and 92% said that they consider sustainability when selecting their purchases.

SABMiller has responded to such consumer sentiment by looking for ways to better manage constrained water supplies and generally protect the environment. The beverage giant wants to reduce its water consumption per litre of beer by 25% between 2008 and 2015. In 2012, it had lowered its average consumption to 4.0 litres of water per litre of beer, a 5% reduction over the previous year.

"Beer is a local business and the success of SABMiller is inextricably linked to the wellbeing of the communities in which we operate. Recognising that we are part of the fabric of society, we seek to generate "inclusive growth" – in other words, to build value chains that drive economic growth and

stimulate social development while using scarce natural resources efficiently. In this way, we can generate long-term returns for our business while also creating wealth for our local communities," the group said in its 2012 Sustainable Development Report.

Brewing accounts for a major proportion of the company's water consumption, and among one focus of the company's sustainability drive to evaluate its consumption patterns and create processes that are more efficient, for example recycling water to secondary uses such as cooling and cleaning. SABMiller has also teamed with the World Wide Fund to create a Water Futures programme to protect watersheds.

With annual revenues of US\$31 billion and operations on six continents, SABMiller's initiatives have the potential to trigger significant improvements for the company and the communities in which it operates.

(More information on the group's efforts can be found in *Sustainable Development Summary Report 2012*, SABMiller.)

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## 5. Ability to innovate

The ability to innovate underpins the other four key areas of focus. Innovation allows companies to find new ways to satisfy customer needs, keeps staff motivated and excited about the future, assures suppliers of a company's prospects, and leads to cost-saving advances in production processes and service delivery. Once a relatively slow process, the

scale and speed of technological change requires rapid innovation and demands dedicated attention in organisations. In terms of environmental sustainability, the scale and nature of the challenges require innovative and creative approaches to business, often demanding new approaches to familiar problems.

## CASE STUDY

### INNOVATION – UNILEVER

The Unilever Sustainable Living Plan (launched in 2010) is the company's roadmap on how it will achieve a doubling of the business while halving the environmental footprint of its products.

At Unilever they believe growth and sustainability go hand in hand, and that sustainability fuels innovation. Sustainability is seen as a fertile area for both product and packaging innovation and leads to the development of new products with new consumer benefits. It also helps develop new markets. Over half of Unilever's sales are in developing countries, which often face the greatest sustainability challenges. New products that help people adapt to the changing world will drive growth.

Unilever R&D has an important role to play in the design and use of its products. Unilever R&D already has a long history of developing products that meet sustainability criteria and have committed that looking to the future all their products will incorporate social, economic and environmental metrics in their innovation plans.

Some recent examples include:

- Comfort Easy Rinse fabric conditioner which minimises the amount of water needed to rinse clothes.
- Pureit, a battery operated home water purification device which gives households in India access to clean, pure drinking water at low cost.
- An upside-down roll-on deodorant that uses 18% less plastic in each pack.
- Small and Mighty laundry liquids which, because of their size and concentration, reduce CO<sub>2</sub>, water usage and transportation costs.
- ProActiv margarines that contain plant sterols, clinically proven to lower cholesterol.

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## Thought starter: the importance of good information for decision making

Management accountants play an important role in providing and analysing data collected around key drivers of long-term business performance. In the case of the Dutch dealership (see pg 10), for example, financial professionals were behind the finding that long-term performance and sustainability could be best served by a shift in focus from transactions and profit centres to lifetime customer profitability.

Armed with such information and analysis, management accountants can redefine effective performance and design new indicators and systems to ensure the desired behaviours are

being encouraged. Providing regular performance reports is an integral part of this endeavour and supports effective decision making throughout the organisation.

In addition, good external reporting to stakeholders forms an essential component of company-investor dialogue. Clear communication allows stakeholders to judge the organisation's performance, position and prospects in relation to achieving long-term success. These external reports should contain the highlights of information that is regularly reported internally. These are all areas covered in the IIRC's Integrated Reporting framework.

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## CONCLUSIONS

The unremitting emphasis on shareholder value had its heyday in the robust markets of the 1980s and 1990s when, for the most part, it seemed share prices could only go up.

Periodic crashes were regarded as inevitable and did not invalidate the core business philosophy. The turn of the century changed that reality. New types of investors – hedge funds, sovereign wealth funds and others – have created complex ownership structures. Then, of course, the global crisis of 2008 brought the debate about shareholder value and short-term strategies into the public discourse. Added to this is the increasing urgency to meet the challenge of planetary sustainability.

Consequently, debates about the role and purpose of the company in society, short-termism and appropriate company structures are not likely to end soon.

Simply to exhort companies to take a long-term view is too simplistic and ignores the challenges presented by the shift in perspective. In addition, some external factors, particularly those relating to environmental considerations, fall beyond the conventional mandate of corporate planning.

Lengthening a company's time horizon requires more than adding a few years to its target deadlines or vision statement. Managers must also align long-term goals and short-term actions. Day-to-day decisions must contribute to the overall health of a company and move it toward its long-term vision. Such harmony between today's activities and tomorrow's success creates a significant competitive advantage. Tools like the balanced scorecard can help companies dynamically manage this bifocal perspective. By focusing on critical areas of the business model – the supply chain, customers, staff, cost leadership and innovation – companies can ensure that their short-term actions support a long-term future.

## CGMA workshop

Hopefully, this report will have given you plenty of food for thought. But how can you translate some of the ideas into action?

Some of the issues raised in the report are not possible for individual organisations to solve completely on their own, for example, the challenges presented by the large increase in “equity churn” in recent years.

Organisations can:

- Clarify what long-term means for them and articulate long-term goals.
- Ensure that their short-term actions are aligned with long-term objectives on a dynamic basis.
- Create a sustainable business model by focussing on five critical areas: cost leadership, durable supply chains, motivated and skilled workforces, customer retention and innovation.

What are the key learnings from the case studies?

- InterfaceFLOR – cost leadership
- Li & Fung – supply chain
- Tesco – workforce
- SABMiller – customer focus
- Unilever – innovation

Which ideas could you use? Are there other organisations that you could look at?

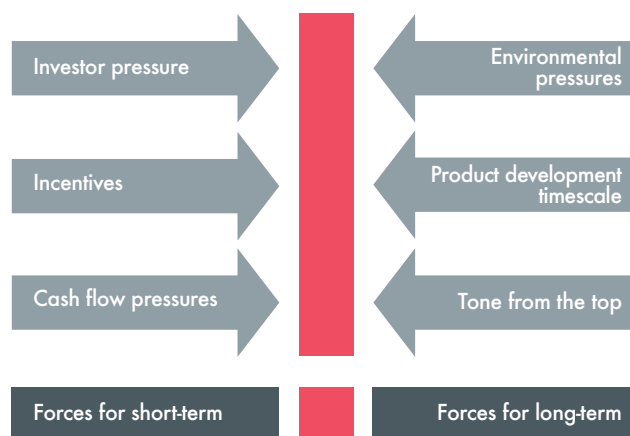
Here are some questions that you might want to consider:

1. How do you define long-term in your organisation? Do you think it is long-term enough?
2. What are the individual, organisational, market and environmental factors that drive a short-term and long-term perspective? Which perspective do you think is dominant?

To do this, you could adapt “force field analysis” to map out the various factors that impact on your organisation’s time orientation. For example, you might identify “investor pressure” as a “force for the short-term” while the nature of your products might mean that it takes a number of years to develop new products. The thickness of the arrow represents your assessment of the strength of the factor.

By identifying all the competing factors and their relative strengths, you should be able to gauge at a glance what your organisation’s overall time perspective is (rather than what you guess it is!) This will then give you a basis for targeted action. An outline example is shown below.

FIGURE 2



3. Does your organisation have a clear cascade of objectives from the high-level, long-term to short-term operational goals?
4. How do you manage the link between the short and long term?
5. Are your KPIs driving the behaviours that contribute to long-term value creation? Are targets being set that foster short-term behaviours?

The case study of the Dutch car dealership, VdU is a good example of how targets were set in such a way that encouraged staff to go for sales rather than customer relationships, which were actually the main driver of long-term profitability. You might want to consider if your organisation has a really good handle on what drives profitability. Are there any obvious information gaps that you could address?

If you are looking for a framework that links longer-term strategy to short-term operational goals and KPIs, the balanced scorecard is a useful starting point.

6. Does your organisation do scenario planning? What sort of scenarios could you consider?
7. To what extent is your organisation embedding sustainability considerations into its planning?



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## Relevant publications

- *Rebooting business: Valuing the human dimension*, CGMA, 2012
- *Sustainable business: Shared value in practice*, CGMA, 2013
- *Incorporating ethics into strategy: developing sustainable business models*, CIMA, 2010
- *Global perspectives on governance: lessons from east and west*, CIMA, 2010
- *Accounting trends in a borderless world*, CIMA, 2010
- *Tomorrow's Value*, CIMA and Tomorrow's Company, 2010
- *Tomorrow's balance sheet*, CIMA and Tomorrow's Company, 2011
- *Tomorrow's corporate governance: the case for the board mandate*, Tomorrow's Good Governance Forum, 2011
- *Sustainability in emerging markets: lessons from South Africa*, CIMA, 2010
- *Enterprise governance: restoring boardroom leadership*, CIMA, 2010
- *CIMA Strategic Scorecard<sup>®</sup> – boards engaging in strategy*, CIMA, 2007
- *Improving decision making in organisations: unlocking business intelligence*, CIMA, 2008

All are available from **cgma.org**,  
**www.cimaglobal.com/Thought-leadership**  
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