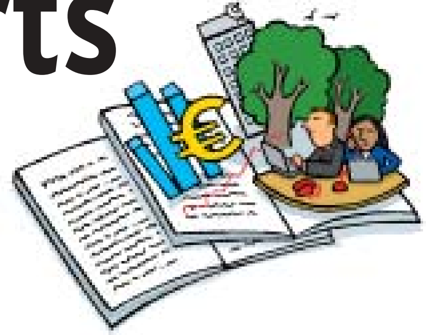
A tale of two reports



Research suggests that corporate reports are more likely to generate rewards in the capital markets if the reader can visualise a link between strategy and areas such as employees, the environment and corporate performance.

by Alison Thomas

Investors care only about the financial numbers. They are short-termists with models based upon the latest quarterly report. Right? Results from a recent experiment conducted in the UK by PricewaterhouseCoopers and Schroders suggest that this traditional portrayal of the investment process is far from accurate. Indeed, it appears that while the models generated by investors may be geared towards exposing the future earnings potential of any given company, the confidence that they have in this forecast – and thus the value that they place upon the stock – is based upon a far richer set of data than merely financial.

To explore this, PricewaterhouseCoopers approached Coloplast, a Danish company that is recognised as a leader in the presentation of total corporate – not just financial – performance. Whereas most companies supplement their financial reports with a simple statement of strategic intent backed up with a few, well-chosen metrics to illustrate performance, Coloplast goes that extra mile. It identifies – and where possible, quantifies – all the key activities that need to come together within the firm to implement strategy and then links these activities to their expected financial outcome. The information set presented is impressive, far outstripping anything that regulatory reporting models require. Such efforts have recently been publicly acknowledged by the Borsen and FSR (the Danish Association of State Authorised Public Accountants) which presented Coloplast with their award for best intellectual capital reporting. But does this corporate transparency make any substantive difference to the information user? Is Coloplast rewarded for its effort?

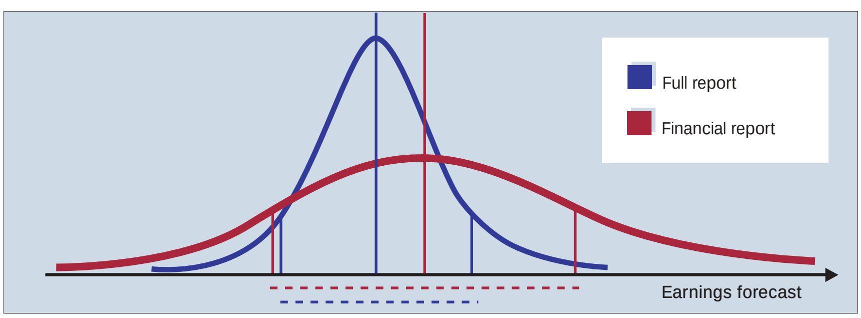
To test this, a PwC corporate reporting specialist dissected Coloplast's 2001/02 report and accounts. Through careful editing, a new version of the document was generated omitting all the quantified, non-financial, data that Coloplast elects to report. The result was a document that complied with regulatory accounting standards and that included the narrative typically provided in the front end of the report, but deliberately excluding the supporting metrics that relate Coloplast's operational performance to its strategic objectives and/or economic outcomes.

So armed with two versions of Coloplast's report and accounts – the original, complete document and the financially compliant document – the PwC team descended on the offices of Schroders, one of the UK's most successful investment management houses. Each member of the research team was presented with one of the two versions of the report and asked to use the information provided to develop a forecast of revenue and earnings for the next two years, to provide a recommendation for the stock, to support that recommendation with their key reasons and to provide their estimate of its beta relative to its peer group – a measure of their perception of the riskiness of Coloplast's return relative to its peers. They had two hours to complete their task – no conferring or external sources allowed!

The findings were quite startling. The average revenue and earnings forecast prepared by those with the full set of accounts were actually lower than that prepared by those who only had the financially-based document. This might be a little discouraging for advocates of greater transparency were it not for the fact that despite the lower forecast, members of the group with the complete information set were overwhelmingly in favour of buying the stock. This stands in stark contrast to those with the less complete information set. Although the average estimate that they generated was higher, nearly 80 per cent of this group recommended selling.

This outcome may be understood through a closer examination of the earnings estimates generated. From Figure 1 it can be seen that the degree of consensus surrounding the forecasts generated by the two groups varied greatly. Those with the full set of supporting non-financial

Figure 1: Spread of earnings estimates generated by investors



measures, with the more complete picture of corporate performance, generated a much tighter range of estimates than those using just financial performance.

This picture is reinforced by the estimates given for the beta of the stock. Within the group presented with just the financial data, Coloplast was perceived to be 'above average sector risk'. By contrast, those who had a more comprehensive picture of overall corporate performance held the stock to be no more risky than its peers.

The reasons given by the investors to support their conclusions are equally telling. Although the investment process that underpins decision-making at Schroders is built upon projections of financial numbers, the confidence attached to estimates is underpinned by any relevant non-financial information provided.

Compare the verbatim comments offered by those with the full Coloplast annual report (see Table 1) with those who were struggling with the financial document (see Box 2). For the sake of clarity the answers were subsequently organised around the key categories of PwC's ValueReporting framework. This is a simple articulation of the building blocks of information that management and the investment community have cited as essential for piecing together a picture of corporate performance (see EBF Issue 5, Spring 2001, pp41-43). It should be stressed that this framework was not used in any way to guide or structure the comments made at the time – the investors simply had a blank box to complete.

Table 1: Key reasons for buying

Market overview

- "Demonstrated ability to grow +10%."
- "Company is gaining market share in most business areas [...]"
- "Niche and high growth markets."
- "Out-performed market since 2000."
- "Within the EU healthcare sector, the stock offers better earnings growth [...]"

Strategy

- "High growth strategy."

Value creating activities

- "[...] new products form an increasing proportion of turnover."
- "[...] large number of patents, high barriers to entry."

Financial performance

- "Attractive valuation on P/E."
- "Record ROIC & total shareholder return."
- "High returns."

Source: PricewaterhouseCoopers

Table 2: Key reasons for selling

Financial performance*

- "Falling ROICs."
- "ROE declining?"
- "EPS growth rates will be below expected market growth."
- "Expensive, P/E, ROIC."

* Comments are provided on financial performance only; One analyst comments on capacity for innovation.

Source: PricewaterhouseCoopers

What one can see is that those who generated their models using more complete information base their estimates upon such things as confidence in the market positioning of the firm, in the credibility of its strategy and in the strength of the innovation cycle underpinning its new product pipeline.

By contrast, Table 2 shows that, in the absence of any supporting information, the investor is forced to try to gain reassurance about the quality and sustainability of corporate performance from the unsubstantiated narrative of the 'front end' of the report and accounts and the audited financial statement itself. It is clear from comments made by the Schroders team that without more substantive evidence of good overall corporate performance cynicism quickly sets in.

The conclusions from this experiment are clear. Those with the full information set were more confident in their forecasts with the result that they awarded a higher valuation to the stock – hence the propensity towards 'buy' recommendations.

Shifting standards: turning confusion to competitive advantage

The move to International Financial Reporting Standards (IFRS) that is to become mandatory across the EU, in Australia, Russia, and parts of the Middle East and Africa from 2005 is no small tweak of the numbers. As Yves Vandenplas pointed out in EBF issue 15 (Autumn, 2003) this conversion will shake the whole basis of reporting for many corporations – not just their external communication of performance, but their whole internal management reporting and data collection systems.

However, in the midst of the many organisational and cultural changes that conversion to IFRS might entail, one recurring theme dominates the agenda of investors and directors alike: how to evaluate corporate performance. How, in a world of greater earnings volatility can we differentiate good management from bad, luck from skill?

The problem, to be fair, is not unique to reporting under IFRS. Indeed, many would argue that the ability to evaluate the financial performance of a company will be far easier when the 'fair value' provisions that underlie IFRS, rather than historic cost principles, are applied. That said, the additional volatility that is likely to creep into the financial performance of a company under the new rules, will make the danger of relying upon purely financial numbers far more visible. As long as the primary tools of managerial assessment are financial in nature, boards and investors alike will struggle to assess both the quality and the sustainability of the operation's performance. As the Schroders/Coloplast experiment illustrates, outside assessment of the prospects of a company are harmed if future forecasts cannot be trusted.

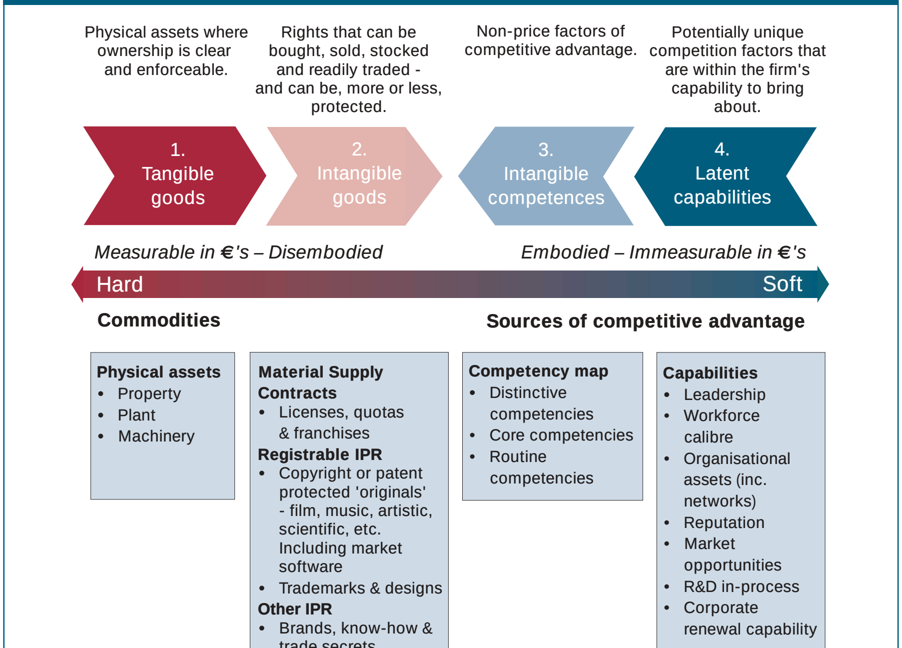
So, given the very real cost that uncertainty about corporate performance imposes upon the price of the capital, what can be done to help a reader disentangle the consequences for published profits of, say, the new mark to market international accounting standard from a fundamental operational problem (i.e. a loss in competitive positioning, diminished corporate reputation)? Can the current reporting model be extended to cover a broader set of performance indicators, or will complementary metrics be required?

Figure 2 offers a schematic of business today. It shows a world in which the latent capabilities and intangible competencies of the company allow otherwise inert tangible and intangible assets to be exploited. In this environment, it is the people employed, the reputation of the firm, the 'know how' that results in a successful innovation stream and the flexibility of corporate structures that are the sources of sustainable competitive advantage.

Codified fifty years ago, in the era of the mass manufacturer, the traditional financial reporting model focused its attention on those factors that are critical for the evaluation of the performance of a large-scale commodity industry – return on fixed assets, inventory position, marginal unit cost of production and so on. In terms of Figure 2, the traditional reporting model therefore finds its roots in the first resource 'chevron' on the left side.

In recent years, the regulated reporting model has made progress in the second of the chevrons – the intangible goods area. Provided there is some market, some apparent mechanism of exchange for an intangible asset, the potential to extend the traditional transaction – or value-based – model to

Figure 2: The resources of 21st century businesses



Source: www.EUintangibles.net

Similarly, when presented with just financial information, uncertainty in the economic projections for the company increased and the value of the firm was questioned.

We can assume therefore that, although investors' analytical models may be financially driven, the factors that allow an analyst to gain confidence in them – such as revenue growth, margin trends – are typically non-financial in nature. Revenue rises because a company is in a growing market and/or is gaining share while market share increases through new product innovation, through areas such as superior customer recruitment and retention policies. Companies failing to make this visible in a credible and well-structured way cannot be surprised if investors assume the worst when placing a value on their estimates of future financial performance.

Does all this drive management to an inevitable increase in the volume of the information that they present? PwC's research suggests that it is the quality and not the quantity of information that will generate rewards in the capital markets. Empirical analysis, moreover, underlines the importance of presenting this information not in silos, not in a series of unrelated snapshots of the various elements of corporate life, but in an integrated format that allows the reader to appreciate how the employee environment, customer performance, and so on, is linked to the strategic objectives of the firm.

This case study reveals the magnitude of the economic benefits that can accrue to companies that offer a more comprehensive picture of corporate performance. In short, there is a competition for capital out there – and every company needs to question whether its corporate reporting is positioning them for success.

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this area has been increasingly embraced by the accounting profession. Much work is still required to ensure that the intangible assets made visible through the transaction-based model are represented in a 'true and fair' fashion. However, the possibility of extending the current framework of evaluation to such assets is not beyond imagination.

But where does that leave the last two chevrons in Figure 2 – the areas that are likely to be of greatest interest to the reader of accounts – being the main sources of competitive advantage? Here the transaction-based framework that underpins current reporting models starts to strain. Placing a value on 'people', or the degree to which the culture of the firm inspires innovation, is clearly not a trivial task. Not least because, in contrast to physical assets, the latent capabilities and intangible competencies of the firm derive much of their value by being deployed simultaneously in multiple tasks, by having increasing returns to scale (as knowledge is cumulative) and from the way 'knowledge assets' can learn from feedback loops.

Such intangibles could still be valued, of course, if there were an organised exchange where they trade – but this is not typically the case. Furthermore, even if there were some pricing mechanism, the issue of property rights would need to be addressed. Although intangible goods may be protected by a watertight patent or licence agreement, the ownership of intangible competencies and latent capabilities are often in question – they have a nasty habit of going home each evening. This makes them inherently more risky than both tangible and intangible goods.

Does that mean that we will have to accept that these areas will remain obscure to the outside world, that they will not be capable of systematic assessment? I would argue not. The fact that such sources of competitive advantage cannot be 'valued' does not mean that they cannot be 'evaluated'. Through the provision of trend data on employee metrics, on the process and success of research and development projects, on changes in customer advocacy data, the reader of accounts should be able to piece together a view of how well the company has been managed and how sustainable is its current financial performance. Examples of companies that are leading the way in terms of the provision of such data may be found in PwCs' annual publication: T*rends in Corporate Reporting 2004: Towards ValueReporting*.

In practice, piecing together the performance puzzle is not as straightforward as it sounds. The first hurdle is to understand the specific information needed to evaluate activity in each company and industry – with the development, where possible, of industry-based standards. The second is to present these measures in a credible fashion – it is the quality of the information provided, not the quantity, that counts. The final – and, for many companies, the biggest – barrier to implementation, however, is the lack of robust non-financial information at main board level.

Reporting is a new competitive arena. For those who understand and report transparently upon their key engines of value creation, the long-term rewards will be tangible: a greater investor following, lower stock-price volatility and ultimately a more attractive cost of equity and debt.