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# Corporate Reporting Revisited

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ABSTRACT

There is an acute and growing awareness across the international investment community that annual reports and accounts currently provided too much emphasise on accounting profit – financial data, and that they are typically out of date before they are released. This is in a large part due to the regulatory environment with which companies must comply, as well as reflecting a tradition of market communication which avoids detail on how business value is created and sustained, concentrating instead on 'hard' financial data.

## I. INTRODUCTION

The efficiency of the global capital markets is underpinned by financial reporting. But true market efficiency can only occur when companies provide the investment community with the forward-looking financial and non-financial information needed to assess time value creation. Investors and analysts need a great deal of information when choosing where to invest in an increasingly diverse and fast-globalising market place.

## II. LEVERS OF ADVANTAGE

Investors do not necessarily want total transparency in company reporting but they do need forward-looking information to feed into their valuation models. If the capital markets, and those who invest in them, are to be steered away from short-term earnings performance and towards the activities which underpin value creation, companies must be encouraged to concentrate on putting systems in place to measure, record and communicate these activities. Progress is being made but it needs to be more strategic and value oriented. More progressive companies now mirror the cash flow valuation models used by investors to drive strategy and resource allocation, and these techniques are being pushed down the organisation through the introduction of value-based management. But the missing link is in the area of communication: a new reporting model needs to be established to complete the chain.

From an investor's standpoint, there are few things more frustrating than companies only high-lighting those areas where they have been performing well. Instead, they should be prepared to publish a balanced and objective picture of performance and where the business is going. Transparent criteria for evaluating investments and other quantifiable targets should be communicated externally. These targets should then be disclosed consistently. Analysts and institutional investors focus much of their research on company strategy. The 'value platform' underlying that strategy and recent surveys of investors' demand for, and use of information confirm their desire for more forward-looking information, as well as the importance of drivers of future performance to their investment decisions.

## III. TAKING A 'BIG PICTURE' VIEW

The most far-reaching research as yet undertaken into reporting practice has been conducted by PricewaterhouseCoopers, which has commissioned MORI to conduct telephone surveys of 445 sell-side financial analysts and 685 institutional investors equally distributed across 14 countries. This research, which focuses on the perceived importance of 21 specific measures of performance conclusively shows that the traditional reporting model is inadequate for the demands of today's capital markets. The findings are emphatic -the market requires information on a wide variety of performance measures, many of which are non-financial, for example market share and market growth, investment into research and development and statements of strategic goals. The research also firmly established that while investors undoubtedly prefer 'hard' data, those who do want *'soft'* data are currently dissatisfied with the way that it is being reported.

The research indicates that analysts require a greater depth of information than investors, reflecting the respective roles of each in the investment process. Across the countries surveyed, less than 20% of investors and analysts regard financial reports as being 'very useful", and although a majority of respondents perceive financial reports to be 'fairly useful', there is a significant disenfranchised 20% which perceives them to be either 'not very useful' or 'not at all useful'.

## IV. LONG TERM VALUE CREATION

The top-10 priorities for both analysts and investors fall into the categories of financial, strategic, market positioning and product development information. This underlines the fact that the most valuable information is either that which is largely strategic and key to long term value creation or that which is required by regulation. Much of the value of this information stems from its comparability and the fact that it has been audited. Outside of the top-10 information types, there is still no consistency in the nature and extent of information being reported and a very substantial information gap exists between what the market wants, and what it is actually getting. Across all 21 measures, the largest information gap lay in informa-

tion on customer retention - 50% of investors attached value to this information, while only 14% felt it was adequately reported. Product quality, employee productivity and R&D productivity information were the other areas where a significant information gap was identified.

This analysis forms part of PricewaterhouseCoopers' ValueReporting™ initiatives, which represents a substantial investment into this brave new world of company reporting and is acknowledged to be the trailblazer in this area. The ValueReporting™ message is straightforward enough - value is only realised if it is being effectively communicated to the capital markets. Put bluntly, investors cannot value what they cannot see - perhaps explaining why so many managers bemoan the gap that they feel exists between the internal perception of a company's potential and that of the stock market.

The ValueReporting model identifies a core group of six value drivers, called the "Value Platform": Innovation, Brands, Customer Value, Supply Chain Efficiency, People Value, and Corporate Reputation. Expanding corporate reports to include information in each of these six areas would not only better reflect the growing emphasis on value creation and preservation by managers but also would provide investors with more of the information they require to assess future cash-flow potential. Discussion topics could include information on the industry in which each business operates, how the company performed relative to management's goals, expected changes and risks faced by the businesses, and an explanation of capital investments the company is making and how this is expected to enhance future cash flow.

In addition to historical earnings measurements, "ValueReports" would also include lead indicators, such as:

- *Market share, which is linked to customer retention and satisfaction,*
- *Quality, which indicates how well* a *company's products and processes stack up against those of competitors,*
- *Human capital, which shows how well-positioned a company is to anticipate new trends and adapt products and services to meet evolving needs of customers,*
- *Intangible assets, which represent a company's ability to successfully implement strategies to remain competitive.*

The first five areas of the "Value Platform," Innovation, Brands, Customer Value, Supply Chain Efficiency, and People Value, are quite familiar, but the sixth element, Corporate Reputation, is an emerging area that is quickly becoming recognized as a vital part of value creation and preservation.

## V. STAKEHOLDER RELATIONSHIPS: THE NEED TO MAINTAIN A DIALOGUE

While it could be argued that shareholders are the most important constituency a company has, businesses, no matter how big, how diversified, or how global, are part of communities. Clearly, shareholders are not the only parties interested in corporate reports. In fact, the audience is large and diverse, and includes customers, suppliers, employees, government agencies, politicians, the media, interest groups, consumers, and even competitors, among others. The interest stems from the potential impact a company's actions can have on them as defined by the issues that each group represents. Examples of such areas of interest include abiding by laws and regulations, controlling pollution and other damage to the environment, providing equal opportunity employment, and instituting fair labor policies.

Just as investors will go to extremes to find information on strategic and operational initiatives, other parties will put an equal amount of effort into finding out how well a company is conforming to issues that matter to them. In fact, scrutiny of corporate responsibility has been escalating as technology has facilitated easier and broader communication. Today, harmful actions in one place can have a substantive impact on a company's business in another.

## VI. REPUTATION REPORTING: ACCOUNTABILITY ADDS CREDIBILITY

Building, protecting, and enhancing how a company is perceived by its stakeholders requires managers to communicate clearly and proactively. Relying on public relations, advertising, and branding does not provide the substance increasingly activist shareholders and community groups are looking for. To effectively and accurately demonstrate good corporate citizenship, reports should include sections that

address the key issues that are important to each company's stakeholder groups.

By making it easier for stakeholders to understand what the company is doing *vis-à-vis* its social and environmental responsibilities, management is acknowledging common ground with others, thereby encouraging a positive view of the company. It is also promoting an understanding of the issues the company itself faces. While good communication will not save a poor management team or Board, it can enhance the value of companies with strong corporate leaders.

## VII. BENEFITS OF VALUEREPORTING

Whether or not companies should make an effort to disclose a broader range of information depends on what they stand to gain for doing so. According to our surveys, the benefits are substantial.

First is an increase in management credibility. While this is admittedly an intangible benefit, it can be an important one when management is embarking on a major investment program that will hurt short-term earnings but deliver meaningful results in the future. In addition, by sharing its goals with investors and then delivering on those objectives, management's credibility is enhanced just as it would be if the company met earnings expectations. In essence, the market will be much more likely to reflect this kind of disclosure in a positive way if it believes management's intentions are sensible and that the company will be able to deliver on its promises.

A second important benefit is an increased number of long-term investors. If companies provide a broader range of credible information on performance measures other than conventional earnings data, and especially if they present a relationship between these measures and long-term value creation, it may be expected that the market's emphasis on quarter-to-quarter and year-to-year earnings would decline. This allows management to focus on long-term growth instead of on activities designed to boost quarterly earnings, which often undercut value-creation activities.

The third most important benefit is a higher share price. Going forward, it all comes down to this: The financial markets will insist upon clear, relevant financial information and capital will flow to where investors see reward and understand the risks. While many aspects of the financial markets have changed, the need for informa-

tion has not: More information means less risk. As it stands, financial reports provide only limited information about the strategies and investments management is making to achieve long-term growth.

Another benefit for managers to keep in mind is that if they do not control communications, someone else will. Companies play a very dangerous game by withholding or, worse, presenting inaccurate information about the company. There are enough independent sources available to corroborate or refute a story. By virtue of the Internet, news can be spread globally within seconds and become visible in stock prices moments later. Finally, in cases that cause management credibility to drop, experience has shown that companies are then forced to become more transparent to reassure the markets. On balance, giving investors the information they need is worthwhile simply because market knowledge is better than market guesswork.