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 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](image-url)
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 task of the new and changing financial 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 reporting and data collection systems 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
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, but 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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