futurevalue

Briefing paper

Never mind the quality feel the width

An alternative review of 2014 changes in corporate reporting

December 2014

1 Introduction

The Department for Business, Innovation and Skills has significantly overstated the reality of material improvements in corporate reporting in its recent Progress Report on the implementation of the Kay Review[1]. Our briefing paper draws on robust research to present what is perhaps a more realistic picture of the scale of improvement in the key areas addressed by these recent changes.

While the Government naturally wants to be able to show the benefits flowing from its efforts in this regard, we suggest it needs to look more carefully at the research it relies on to evidence real improvement. In other words it needs to pay more attention to the 'quality', and less to the 'width'.

This Briefing paper addresses the findings from the research quoted in the BIS Report. It uses FutureValue's own research data, to present a rather more rigorous, grounded and objective appraisal of the findings. It concludes with suggestions that flow from reality, and are not based on smoke and mirrors.

2 BIS observations relating to implementation of the Kay Review

In October 2014 BIS published a progress report on the implementation of Professor Kay's 2012 review of UK Equity Markets and long-term Decision Making. Under the heading of 'Encouraging high quality narrative reporting' this BIS report declares in paragraph 2.37 that:

> *"The Kay Review recommended that: "high quality, succinct narrative reporting should be strongly encouraged" Specifically, Professor Kay observed that: "Good quality narrative reporting can put the financial results in context, highlight important factors and communicate strategy and risks to investors in an understandable, engaging and concise format."*

In paragraph 2.39 it goes on to explain the new regulations introduced in 2013 in support of the recommendation in 2.37:

> *"The new regulations came into force on 1 October 2013. They removed some disclosure requirements altogether, and require that all companies, with the exception of small companies, produce a separate strategic report as part of a restructured annual report, presenting key information about the company's strategy and business model, and insights into the challenges and opportunities for the company in the future. In line with the recommendations of the Kay Review, our aim was to make reporting simpler, clearer and more relevant to investors' understanding of the business, as a catalyst for more effective engagement and dialogue between companies and investors on the creation of sustainable long-term value."*

Then, in paragraph 2.40, it discloses how companies have responded to these new regulations:

> *"There is good evidence that companies have responded positively to the reforms. A recent research report […] analysing trends in the 2013 annual reports of FTSE100 companies, finds that there has been a significant improvement in the key areas addressed by the regulations. The report highlights in particular that:*
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> *• 97% of companies are now providing a discussion of strategy – with 88% of companies defining and addressing specific strategic objectives against which they can be held to account*
>
> *• 95% of companies are providing a detailed discussion of their business model*
>
> *• 94% of companies discuss clear business objectives in their reporting, with 86% focusing to some extent on long-term objectives; and*
>
> *• 83% of companies provide either a link from their identified key performance indicators to the overall strategy or to specific strategic objectives.*

3 FutureValue's observations

FutureValue has been measuring the quality of narrative relating to the key areas addressed by these new regulations since 2006. Our results have never been disputed, form the basis of a prestigious awards programme that reporters and their advisers are keen to be endorsed by, and are the foundation of several FTSE companies' own reporting developments.

Our recognised strategy expertise, our independent research and our rigorous consistent evaluation of corporate reporting by listed companies have earned us an authoritative reputation. We have established that a disciplined and well-articulated strategy framework, embodied in an Annual Report, can be a reliable indicator of future longer term potential, just as audited accounts are an effective measure of past performance.

The one thing investors like least is uncertainty. A well-articulated strategy framework can project realisable future potential and reduce that uncertainty. In the best cases it may even inspire positive investment activity. To assess the 'uncertainty quotient' in an Annual Report FutureValue evaluates the quality of strategy discussion against a simple, logical strategy framework that is fundamental and well known to any experienced strategist. This permits us to look beyond the presence of the printed word and use of management jargon to assess content. We score each narrative against a number of factors.

Our evaluation of how companies have responded to the new regulations in 2014 builds on our comprehensive research assessment of FTSE100 companies (and others) over the past seven years. It yields a divergent, but maybe more informative and useful, collective picture of FTSE100 reporting than is presented in the BIS Report.

We can show that the general quality of reporting has shown gradual improvement over the last eight years but has not reached the elevated standard that the BIS is proclaiming based on the research cited in their report.

Our trained and experienced analysts assess more than thirty elements influencing strategic value in each company's Annual Report. Our scoring system has a maximum overall score of 10.0. The average overall score for the quality of strategy narrative in FTSE100 companies has increased only gradually over time – from 5.9 in 2007 with the inception of the Business Review, to 6.4 in 2014 with its replacement by the Strategic Report. The change is modest, in spite of the best of intents, the efforts of the FRC and copious guidance and advice.

To put this into context, we estimate that a third of all FTSE100 companies fall short of a standard in their corporate reporting that might be of benefit to the attitudes of current and prospective investors.

It may be helpful to relate our research data directly to the four 'key areas' quoted by BIS in its Report:

3.1 "97% of companies are now providing a discussion of strategy – with 88% of companies defining and addressing specific strategic objectives against which they can be held to account"

We agree that the overwhelming majority of companies make use of the word 'strategy'. We would challenge whether anywhere close to 97% actually provide 'a discussion' of strategy that is of much real value – we would place the figure at 36%. Nor can we find any hard evidence that 88% of companies 'define and address specific strategic objectives'.

There is clearly a misunderstanding of what 'strategy' is, even by leading companies, let alone commentators and researchers. There are typically three reasons for this. Many companies are unable to differentiate between their business model and strategy, which creates confusion. Others seem to present an operational plan or short-term priorities labelled as 'strategy' – this may conceivably be re-visited in the scramble to produce and help underpin the new 'viability' statement. There are also companies that present a generic set of statements labelled 'strategy', thus demonstrating a dearth of any strategic understanding, thinking or analysis. For example, one company's five-part 'strategy' is 'Identify, Invest, Develop, Promote, Achieve'.

We can only conclude that the lack of a specific agreed definition for the word 'objective', and the consequent differing interpretations of what an objective is, may be the reason why FutureValue can only credit 32% of companies as having a meaningful goal or objective against which these companies can be measured. This is somewhat short of BIS's quoted

figure of 88%. We revisit this issue in greater depth later when addressing BIS's third finding specifically about objectives, in 3.3 below.

3.2 "95% of companies are providing a detailed discussion of their business model"

We concur with the quoted research that a very high proportion of companies mention a 'business model', possibly because the law requires them to, but a much smaller proportion provides "*a detailed discussion*". Whether that discussion of the business model is then of any value to investors remains highly questionable in many cases.

Our research shows that only 37% of companies present and discuss a true strategic business model. These are the only business model expositions that are of any real worth as they explain why a company is profitable. In these cases the business models are the foundation to the strategy framework of the respective company or group. Why a company creates value is what really matters to investors. Having a clear idea of the distinct sources of value that drive profitability projects the potential of a company and establishes the drivers of growth. One can only answer the 'why' by matching a company's external circumstances to its internal realities.

Many of the other remaining 63% of companies are compliant because the FRC has permitted companies in its guidance on the strategic report[2] to take a rather *laissez faire* approach and label pretty much anything as a business model. Many present a purely operational business model that is solely internally focused and does not look outside the business. 'How' a company creates value merely explains the operational processes of the entity – 'If you turn the handle here then this is what you get out at the end'. It is interesting and puts flesh on the 'why' but on its own 'how' will not reassure, let alone inspire investors. 'Why' sets the foundation for the goals and strategy. 'How' is the operational consequence of the strategy.

The permission for an internally focused operational option is probably because accountants have formerly used the term 'business model' to reflect the operational processes of a business. An operational business model cannot be applied to a group of companies, which is a common structure for a PLC, unlike a strategic business model. It is also of very little value at all to investors.

In the case of 29% of companies, FutureValue's research shows that there is either no business model, the model is indistinguishable from the strategy discussion, or the model simply explains what the company does.

We are also aware that the desperation to comply with this new regulation has driven some companies to ask their annual report designers, "*What is our business model?*" even adding "*Is it a circle, a square or a triangle*?" One has to wonder if they also ask these same designers what their strategy is…?

3.3 "94% of companies discuss clear business objectives in their reporting, with 86% focusing to some extent on long-term objectives"

We find it impossible to come anywhere near the remarkable percentages in the BIS quoted research. As stated in 3.1 above, FutureValue can only credit 32% of companies as declaring a meaningful goal or objective that provides both context and focus for their strategy, and against which 'they can be held to account'. The remaining 68% report a vague goal, a shareholder value goal, or no goal or objective at all. There are a number of possible reasons for the scale of the discrepancy.

First, the researchers in question have been loose in their interpretation of what are 'business objectives' and 'long-term objectives'. Strategists agree that the word 'objective' has a specific meaning: the quantification of a business goal – in other words, an objective is specific, time-defined and measurable[3]. Where companies have used 'objective' in the 2014 reporting cycle, very few cases were either time-defined or measurable. Most occurrences were merely vague unspecified ends, sometimes qualifying more as 'business goals', a term less rarely used, but then the regulatory guidance asks for 'objectives', not for 'goals'. Occasionally, some companies use the word 'vision' – in effect, the aspiration or desired future state of the enterprise – as an alternative to 'objectives', and then in some cases even attach a measurable objective. Unilever is an example of this, declaring that: "*our vision* [by 2020 is] *to double the size of the business while reducing our environmental footprint and increasing our positive social impact*." To the strategist this is not a vision; it is a specific and measurable long-term objective. Loose usage of strategy terminology by companies and the absence of a rigorous strategy lexicon in the FRC's guidance conspire here.

Second, 'increasing shareholder value' is not a long term 'business objective'. It is a financial goal and an outcome of the business strategy. In 2008 Jack Welch, management guru and formerly Chairman of General Electric, also credited as 'father of the shareholder value movement' nearly three decades earlier, declared that he had been misunderstood and that the whole idea of 'shareholder value as a primary goal' was wrong[4]. It seems a high proportion of reporting companies in the UK have yet to catch up on this. 'Shareholder value increase 'or similar non-specific 'sustainable growth' goals are not long-term objectives. These are widely used and will surely have been included in this research as 'business objectives'.

Third, reporting companies sometimes present the elements of their strategy as a series of objectives or priorities when they fail to include an overarching goal or objective to give both context and focus to the strategy. In other words, companies leave out saying what they are trying to achieve. The elements of the strategy to achieve that undeclared goal then become a de facto set of operational objectives in their own right. Indeed, it is only with a clear long-term business goal declared that it is possible to tell easily and intuitively whether the elements of a strategy are both individually necessary and collectively sufficient means to deliver that declared goal. The omission of a goal in this manner shows a weakness in strategic thinking and comprehension in a company, although in some cases the purpose of the omission may be merely to obfuscate.

3.4 "83% of companies provide either a link from their identified key performance indicators to the overall strategy or to specific strategic objectives"

The provision of a link from identified key performance indicators to the overall strategy or to specific strategic objectives is for a quite specific purpose. It is to demonstrate strategy in action and better still, if there are clear business objectives, to give evidence of progress made towards those objectives.

There is very little value in counting links from strategy or objectives to KPIs if the KPIs are of limited use to investors in that context in the first instance. The heritage of KPIs in the Annual Report has two strands; one is from a suite of financial metrics that set short and/or long-term reward incentives for executive directors. They had no strategic value other than to link remuneration to financial achievement. The other, from which 'best practice' developed, was from Corporate Social Responsibility reporting. The CSR community have understood, produced and used KPIs for a long time – to demonstrate progress against defined objectives and to support the case for investment and expenditure against them. Many CSR reports are more strategically coherent than the Annual Reports they accompany.

For many companies financial metrics still remain most of their declared KPIs. The usual additions are the 'non-financial' – typically CSR – and 'operational' – typically employee engagement and customer satisfaction. Very rarely do any of these measures, financial or otherwise, provide usable direct indicators of strategy in action, even though they are cross-referenced to infer such, and so count as having a 'link'. The links appear to be there to tick a 'joined-up, logic, linkage' box, as opposed to being material.

Our research indicates that only 51% of companies present meaningful KPIs. Of these 51 only 34 present KPIs as reasonably effective measures of strategic progress. FutureValue does not count links, although we do look for and measure 'coherence'.

4 Conclusions

We understand why BIS wants in its report on implementing the Kay Review to be able to throw the best light on its efforts to "*to make reporting simpler, clearer and more relevant to investors' understanding of the business*." But we maintain that it needs to look more carefully at the evidence it relies on to demonstrate that improvement. It also needs to be more realistic about its achievements here.

We must add that we have not had access to the research quoted in the BIS report or its methodology. However, the statistics presented in that report are clear, rigorous and unambiguous, and invite the reader to make judgements based on these metrics.

There are two distinct issues here. One is the erroneous assumption by researchers that the words in the Strategic Reports of FTSE100 companies add up to a robust and meaningful framework of strategy statements. This is the less serious of the issues. It merely misrepresents what is actually going on. The

more serious issue is that a significant proportion of FTSE100 companies give the impression that they are applying credible and enlightening strategy thinking to enlighten investors and reduce their sense of uncertainty about that company. This is not just an issue of misinformation. Of far greater concern here is the apparent inability of many of our largest companies to think, lead and manage strategically. Many seem to be using the language of strategy without any evident understanding of strategic context.

The Government has recognised that the articulation and presentation of a coherent business strategy is critical in helping to reduce uncertainty for investors by projecting reliable future potential in a credible and confidence-building manner. The introduction of the strategic report and mandatory business model and strategy are testament to this. Yet, our research has established, year after year, that a large proportion of the UK's leading listed companies demonstrate a limited knowledge of business strategy, verging on strategic illiteracy, and maybe turning to their auditors and report designers to fill in the gap. Little has changed with the introduction of the strategic report. Too many companies still apply the terminology of strategy more as a blizzard of jargon and devoid of the rigour and clarity of strategic thinking. Their words have little substance and offer limited value to their investors.

If the Government wants companies and their investors to communicate more effectively as it declared in its Report then it needs to recognise that it will take more than the ad hoc usage of the lingua franca of strategy for its initiative to be truly effective.

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[1] Building a culture of long-term equity investment – Implementation of the Kay Review: Progress Report; Department for Business Innovation and Skills; October 2014

[2] Guidance on the Strategic Report; Financial Reporting Council; June 2014

[3] Exploring Strategy Text & Cases; Johnson, Scholes, Whittington; Eighth edition; p13

[4] Replacing the 'dumbest idea in the world'; Financial Times; 13 April 2010