

## Corporate substance and relevance –or another definition of “CSR”

How to square the inevitable and increasingly rapid changes in the economic, market and geopolitical environment and their impact on reporting with a fair report assessment and rating?

In other words, how to check the relationship between company value and report value –if any? How not taking everything -or at least too many “things”, including messages, strategy, description of (changes in) business and... the numbers- at face value? And getting down to “book (or should we write “fair”) value”...

We got back to the basics 1-0-1 of what an annual report should be about: a **corporate** communication vehicle based on and delivering **substance** (and if possible making this in style). A document that is **relevant** on a number of issues and questions that go beyond the quarter, filing purpose and compliance, blips and images, and mean something to shareholders, investors and other stakeholders. Everybody is now familiar with the CSR acronym, which stands for “*Corporate Social Responsibility*”. Well, we believe it might as well mean “*Corporate Substance and Relevance*” when it comes to its application to annual report input and output, and analysis and rating. To use another concept that should be more than a buzzword: it’s about **sustainable** reporting, too.

Besides fundamental questions about companies’ decisions and strategies which are outside our scope, recent trends and ongoing events have led many, including us, to question some (and for some all) of the annual reports’ features – should we write virtues: clarity, quality, validity, intelligibility, transparency, credibility.

- **The fear factor.** An increasing number of companies toe the line by publishing a 10-K (or 20-F for foreign listed ones), without any further reporting commitment or value added to help understanding the numbers (and behind) and their underlying components. Those are especially American, but hundreds of others have aped the model. An example among many: Toyota which, after years of improvement has leveled off and much Americanized its reporting format, not

always for the better, and whose report is now almost as difficult to get hold of as... General Motors' one! Mind the ga(a)p, report drivers!

It is a paradox of today's financial markets where everything (a lot of things, really) seems to be permitted that reporting often seems to be totally inhibited by the fear of scrutiny. This is illustrated among others with those cautionary statements, which, without being stretched that much, almost imply that the company (and report) cannot be held responsible for any action! On some shores and plains (not only western), annuals are introduced with boilerplate or corporate claptrap -such as the often hollow *"Managing for shareholder value"*. Then sometimes follow some pictures -*"one of the great things about books,"* said one day G.W. Bush- to embellish. And then? To paraphrase another "bushism", *"It's clearly a report. It's got a lot of numbers in it."* The British leadership's expert Robert Heller wrote that a key feature of strong leadership may be summed up by: *"Be governed by what you know and not by what you fear."* This is not far from a Jeffersonian issue. Too many reports (and not only annual ones) are produced for covering (pun intended) purpose only, and are not playing straight about what the company (management) knows and what stakeholders should know, making their validity and sincerity questionable.

- **Sarbox (or Sox)**. Chalk this up to the fear factor to a large extent, and the rise and fall analyzed in our tenth anniversary issue. The post-Enronitis, a sickness that affected many more than just a *"Dirty Dozen"* has turned into a *"synonym for heavy-handed regulation"* imposed by SEC (Financial Times, August 1, 2007, about five years of Sarbanes-Oxley). Some say it has perhaps increased the quality of account reporting. As far as we are concerned, we doubt it. Reporting is more regulated but it is made to the detriment of medium-term financial analysis and overall clarity. *"There is a concern that the financial review will turn into an unwieldy document with so much information that you can't see the important information,"* said a head of the English and Welsh Institute of Chartered Accountants in 2005 (Financial Times). We're getting there. The result: many North American financial sections are now as dull as dishwater and just differ by the numbers, some of them not within reach and hard to compare. Others point to governance improvement helped by Sarbox? Really? Look at the number of CEOs still chairing the board, and those sitting on multiple boards –

can someone explain how a full-time executive can be an effective director on other company boards and committees... or at his/her "own" one? And the way governance and related matters (e.g. compensation and independence) are reported is still patchy, not to say phony in many cases.

- **Great or just big?** How not to say a word about the merger frenzy? As many deals were announced in the first six months of 2007 as for the whole year 2006, and records of private-equity investments have been beaten month after month. As authors such as Jim Collins ("*Good to Great*") and Bo Burlingham ("*Small Giants*") put it, size for the sake of size has become the mantra of today's capitalism. Among many examples of this is the farce around the planned acquisition of the Dutch bank ABN Amro, for which no less than four European big shots were still bidding when we wrote these lines, after almost one year of speculation. Multiple studies have shown the limited impact of M&As in general and in the financial sector in particular. Bar a few noticeable exceptions, "limited" often translates as negative for clients, shareholders, and employees. Apparently, bank and insurance boards don't care as much about those reports as, say, about improving customer service. Reality checks are to be found aplenty, from the Pfizer indigestion to the Daimler "merger of equals" –now almost a humorous expression nevertheless often copied and pasted since then, e.g. as a branding exercise (ChevronTexaco, Alcatel-Lucent, et al.). Still, those "dear" analysts keep on talking of consolidation, and those cherished funds keep on pressing or pushing around. How about reporting in hunter and hunted times? Most pre- or post-merger situations result in bigger reports, but certainly neither in greater nor better ones. Whether for the acute observer or the poor (?) stockholder, measuring the actual impact of acquisitions (or divestments) and external growth often turns into a headache for which calculations and comparisons are rarely optimized, or simply provided, in annuals.

- **A credibility gap.** Perhaps one of the most worrying developments of these last years and months, which often clashes with the claims of accountability and responsibility.

What to think of and how to judge the relevance of reports from: e.g. BAE on "support services" (great understatement there) and political responsibility;

Carrefour on fair trade (remember those Danish goods withdrawn for cartoon reasons?) and governance (from one boss to another); Goldman Sachs on remuneration; VW and Audi or Porsche buddies on “interacting” governance; BP on safety vs. profit, and something else at the top; Chiquita on the Colombian connection (we mean, segmentation); Delphi on employee compensation; General Motors on pension accounting; Bear Stearns on reporting exposure to markets and mitigation measures (not) taken; Suez and GDF on long-lasting pre-merger window dressing; Halliburton, many other contractors, and a few “generals” on responsibility (no added word needed here); the oil bigwigs on “proved reserves”; and so on.

How to judge the degree of transparency and credibility of a report about such malfunctions or malpractices? That’s a tough issue. Because, taken to extremes, it makes the report that precedes or follows the events or situations irrelevant –or almost. Bearing in mind that our ReportWatch checks report value and not company value, we have gone for a selective approach, leaving out some which really don’t pass the credibility test, checking others, and showing mercy to some (even shown in higher marks) whose annuals pass the exam on important reporting features, in spite of lagging behind on core issues.

**- Face value?** *“November 17, 1998, saw the birth of DaimlerChrysler –a child with extraordinary genes and potential. We are coming together as one...*

*DaimlerChrysler has tremendous opportunities and a clear vision that will set us apart.”* (Joint Chairmen’s Letter, DaimlerChrysler Annual Report 1998).

*“The stock markets have not yet given tangible recognition to our achievements, nor to our potential. During 2002, DaimlerChrysler has made significant progress on its way to sustainable profitability.”* (Chairman’s Letter, DaimlerChrysler Annual Report 2002).

*“In 2004 your company once again made significant progress in spite of... difficult circumstances. Chrysler Group achieved a turnaround and performed very well... I believe that you too, as shareholders, appreciate being part of a company that has both heart and sound business sense.”* (Chairman’s Letter, DaimlerChrysler Annual Report 2004).

*“The strategic Transformation Process aims at redesigning the Chrysler... business model in such a way that it will remain profitable in the long term...”*

(Chairman’s Letter, DaimlerChrysler Annual Report 2006).

*“Managing for shareholder value, sustainability, responsibility, und so weiter”*

(fictitious Chairman’s Letter, Daimler AG Annual Report 2007).

That sums it up: a report -and statements- should not be taken at face value.

**- The point of return.** Ratios should remain an important constituent of annuals. According to our estimates, not more than 50% of reports calculate the return on equity (ROE) over three or more years, and this percentage is even lower in U.S. reports, where ratios and returns tend to be left to the reader (read: funds’ analysts) to be calculated. That proportion hasn’t varied significantly over the last five years. So little that some may wonder how much (some) companies -and their corporate officers and reporters- still care about a ratio that stands as one of the key measures of profitability... and a primary indicator of the so much trumpeted “shareholder value”. Though very worthwhile and rather meaningful in a bigger lender perspective, the broader defined ROI or ROC or ROIC are sometimes used as a smokescreen, and anyway underused beyond some European or Japanese shores. As no smoke detector is usually provided, they often blur relevant profitability analysis.

In relation to the size issues (see above), is it really surprising to see so few companies seeming to care and measure the return on assets (ROA)? No, as size (we didn’t write weight) has become the main measure for so many.

The various levels of margin and return on sales -from EBIT-something to net before or after “everything” (or almost)- are often more generously reported than other ratios. But grasping organic growth for instance -for those who still give little heed to this despite statements and promises- is still a complicated job.

**- Outlook not expressed.** In a special issue of the Harvard Business Review (July-August 2007), Geoffrey A. Moore (a venture partner with a Californian firm) states that *“To Succeed in the Long Term, Focus on the Middle Term”*, adding that *“Strategy’s no-man’s-land lies between the budget and the long-term plan.”* In his as well as in other strategic consultants’ opinions, projects -and may we add reports- with a time horizon *“require processes, metrics, and performance*

*targets.*” Sometimes, and not always for legitimate accounting reasons (such as the switch to IFRS or various GAAP reconciliations), the comparability and continuity of figures are hard to decode. This may also result in questions on the reporting process or even about the strategic course. Key performance metrics or indicators (or KPIs) should therefore be provided in all reports. The least that can be said is that the so much hyped KPIs are far from equally distributed, relevant and significant in hundreds of annuals. These even less set out goals and set medium- to long-term targets that would substantiate a simple auditor-labeled “Outlook”. This looks a bit contradictory with the so-called “guidance” made on quarterly basis and often disclosed much more shyly over the longer term. Was a crystal ball needed to predict -and anticipate- another real estate boom and bust? (Well, the New York Times wrote in August 2007 that *“investors were blind to coming U.S. mortgage crisis.”*)

A major *raison d’être* of annual reports should be to set (out) and chart the course, and to explain possible changes -past, ongoing and future- in this course. Reporting numbers is a matter of the utmost importance. But putting figures in perspective is certainly as important. Even though they are on the rise, annual reports meeting those three strategically driven standards and reporting accurately and thoroughly on their measures still represent a minority.

Based on the above trends and facts, as well as other considerations (see the Editor’s Note), the ***Annual Report on Annual Reports 2007*** does not feature a ranking. You can perhaps chalk that up to the increasing volatility...

Instead, we have turned the spotlight on 250 annuals, selected among 500. And, thanks to a reinforced and deeper scanning methodology, now based on 50 report items (against 25 previously), we have identified some of the best -and many among the not so good- across the board and on a number of attributes.

Here is the good news. Come rain, shine, or climate change, there are still corporate, substantial and relevant -in one word: **great-** reports!

Editorial comments to the “**Annual Report on Annual Reports 2007**”, by Mike Guillaume. Franklin Manchester and Jérôme Pétion contributed. All rights reserved. Copying for other than personal or internal company use is prohibited. Quoting is authorized with appropriate reference.