

In search of clarity in corporate reporting (I)

By Reg Pauffley

I recently attended the 2010 Strategic Value in Corporate Reporting Awards in London, and I thought that you might like to know about some of the awards. These were focused on British companies. In future columns I will have opportunities to talk about international firms, as there are very good examples of best practice in the global marketplace.

The event is organised by the Strategic Planning Society (SPS), and I spent an enjoyable evening finding out more about the Society, and its fundamental belief that future potential and worth can be judged by **how well a company puts into words** its strategic thinking. Indeed, these awards are presented to companies that demonstrate the highest standards of strategy disclosure and commentary in their annual reporting. The keynote speech was made by Stephen Haddrill, Chief Executive of the Financial Reporting Council. During a very interesting speech, Stephen said that *"it is fundamentally important that good reporting gives investors and the public an understanding of what the business is trying to achieve, and that its business model and strategy is clear...the narrative plays a central part in achieving this"*.

In its literature, the SPS sets out how the effective use of narrative in corporate reporting, and particularly the part that strategy-related commentary plays in it, is a long overdue evolution of how the world judges and values companies. Their position is that we can all compare companies today as part of the reporting framework driven by statutory requirements, but **how a company articulates its strategic thinking**, planning and management offers a much more sophisticated measure. I agree wholeheartedly with this, that for all stakeholders to interpret the future success of a company, they need to know and to understand what the business strategy is.

It was fascinating to learn from the SPS that the average difference between **book value** and **market value** of listed companies has grown in the last 50 years from a typical **ratio** of 1.25 to 1, to more than 3 to 1.

As they point out, *"what makes up this growing pot of hidden value?"*

Clearly **numbers**, whilst important, are not as helpful as a basis to forecast future performance as we might expect. When it comes to the future, **words** are more important than numbers and particularly when those words are expressed using the discipline of

corporate strategy. We all know that just as companies file their accounts annually, so they must also file a narrative report as part of that same document. Best practice dictates that a narrative report should contain details of their objectives and strategy, operational performance and key performance indicators, principal risks and uncertainties, resources and strengths as well as commitment to social ethical and environmental matters. And so stakeholders can make comparisons. The SPS says the apparent correlation between the quantity of narrative disclosure in annual reporting and share price information was documented first by academics in the US in the late 1990s. But where the SPS, together with the specialist research firm FutureValue (go to <http://www.futurevalue.co.uk/>), have taken this a very significant step further is to compare **not the quantity** of words, but the **quality of narrative** in annual reports.

They have established that the actual quality of strategic capability that a company puts into its narrative reporting provides an indicator of the potential to achieve high levels of performance and sustain growth. Each company uses the same regulation and has access to the same guidance to produce its narrative, and so has the same opportunity to add the maximum value going forward. The investment banking division of the French BNP Paribas, has validated the methodology, and is looking at building an index using it.

The SPS applies FutureValue's Strategic Value Analysis technique, with its individual comparative assessment of FTSE350 companies, as the rigorous, uncompromising standard for selecting the winners. The 2010 awards relate to content of Annual Reports for years ending between 1 October 2008 and 30 September 2009. For those who have missed the event and results I will review some of the awards -and awarded reports- on a number of key... strategic issues.

Best Strategy and Objectives

At the core of a Company's annual reporting and the disclosure of its capacity to generate future value is the narrative exposition of its objectives and strategy. The exemplary strategy discussion will: review industry, markets and competition; explain the business model; outline purpose and mission as well as goals and define the strategies to achieve those goals. It will also address divisional as well as group strategy and objectives, where appropriate. This award recognises the most coherent and complete articulation of objectives and strategy by a FTSE100 or FTSE250 Company.

Of the four companies short-listed for this award, the judges concluded that one evidenced notably a group-wide capacity for

strategic thinking. There is a strong, pervasive strategic theme to the **Brit Insurance Holdings'** 2008 narrative – at Group, business unit and functional levels – communicating the sense of a business that is strategically led and strategically managed. All too often use of a 'Q&A' style in a CEO's report can seem trite and insubstantial, and this is invariably due to the quality of the questions posed to the CEO. Here the questions are strategic, focused and help to knit the strategic value adding narrative into the cohesive whole of the narrative and the Annual Report.

Other shortlisted companies were: Aggreko, British Airways, National Grid.

Best Strengths and Resources

Growth strategy requires continuing investment in the enterprise. Most of this investment in customers, employees, partners, suppliers, distributors and the organisation itself is beyond the balance sheet in hidden assets that are the strengths and resources essential to future growth. Companies that think strategically understand how these strengths and resources are fundamental to their future success. They also know that it is important to communicate those strengths and resources as evidence of the capability that will enable them to deliver their strategy and achieve their goals. This award recognises the most comprehensive coverage by a FTSE100 or FTSE250 company.

Strengths and resources coverage in an Annual Report is the collective expression of a company's strategic capability. This array of references dotted through the narrative provides Report users with evidence of investment in the underlying capabilities the company in question needs to deliver its strategy and achieve goals. Each of the four short-listed companies does this particularly and consistently well. This year, in the judges' opinion one company, **Amlin**, matched its reported investment in strengths and resources most closely to the demands of its strategy with a particular focus on knowledge, process and leadership. Amlin also managed to capture how it is working across its organisational boundaries with its partners, distributors and suppliers to leverage value.

Other shortlisted companies were: Legal & General Group, Premier Farnell, Serco Group.

Best Sustainability Reporting

This is a new award this year. Sustainability is integral to strategic thinking and to strategic management. Many companies prepare a separate sustainability or corporate responsibility report. What really matters, 'though, is for a company to show how it integrates

its approach to social, ethical, environmental matters and the related governance processes into the overall strategy for the business. The Annual Report is the key document for demonstrating the interdependent linkage and communicating the coherent discussion. This award recognises the best sustainability in annual reporting by a FTSE100 or a FTSE250 Company.

This is a new award this year. Sustainability is integral to strategic thinking and strategic management. Many companies prepare a separate sustainability or corporate responsibility report. What really matters, 'though, is for a company to show how it integrates its approach to social, ethical, environmental and the related governance processes into the strategy for its business. The Annual Report is the key document for demonstrating this interdependent linkage. There are two mining companies in the short list reflecting major strides being made in this sector and both of these are exemplary. A majority decision by the judges resulted in the award going to **Rio Tinto** for its 2008 Annual Report. Rio Tinto conveyed to its Report users an integral commitment, sensitivity to a wide range of stakeholders, close attention to environmental management and a fundamentally ethical approach. Independent assurance and external validation serve to confirm the Group's credentials on this issue.

Other shortlisted companies were: Land Securities Group, Lonmin, Northumbrian Water Group.

Do you think companies -and your company- are equipped to meet the challenge? Let me know your views by e-mailing me to reg.p@creativeconsortia.com