



The Institute of  
Chartered Accountants  
in England & Wales

# Inside Out

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Reporting on  
Shareholder Value

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## Preface

This discussion paper is issued by the ICAEW Financial Reporting Committee at a time of growing awareness of the limitations of external corporate reporting. Its proposals come from a broadly based Steering Group of senior financial managers from business together with key representatives from the accounting profession, investor relations, fund management, financial analysts and the academic community.

As a response to calls for change the Institute has instigated a review of the entire process of communicating information externally in 'The Corporate Report-New Horizons'. This wide-ranging review will consider, inter alia, the demand for more information on intangibles, future prospects and stakeholder issues together with the impact of globalisation and information technology on reporting.

This paper brings to that over-arching review a perspective on the accountant's traditional contribution to the communication process, the annual report. We make proposals designed to meet investors' increasing focus on 'shareholder value' creation and, therefore, their growing demand for information about the future prospects of a business.

The paper builds on the Financial Reporting Committee's earlier work on financial performance and risk reporting. The January 1999 discussion paper "Financial Performance: Alternative views of the bottom line" noted that the underlying financial performance of a business is best represented by the change in its economic value, that is, the change in the net present value of its expected future cash flows. However, it concluded that, because the future is uncertain, changes in economic value cannot be reported as a matter of fact. We need, therefore, to supplement measures of performance with narrative disclosures and indicative measures of future potential for creating value.

In December 1997, our discussion paper "Financial Reporting of Risk: Proposals for a Statement of Business Risk" made recommendations for the enhanced reporting of that aspect of future prospects. A follow-up report in July 1999 "No Surprises: The case for better risk reporting" reaffirmed the view that enhanced disclosures about key business risks and how each risk is managed and measured would provide practical forward looking information and help meet investors' needs. The report also acknowledged that companies' risk management could only be understood in the context of the strategies adopted by management. The present discussion paper focuses on disclosure about those management strategies and indicators of their effective implementation.

The common thread linking these projects, including the present paper, is the need for enhanced information about business performance reflecting a more forward looking focus.

We encourage readers of this paper to send us their views:

- If you support our proposals let us know and, even better, send us examples of corporate reporting consistent with them.
- If you believe that there are further implementation issues that should be addressed tell us what they are.
- Or, if you believe that our proposals are wrong in principle, tell us why.

Comments on this paper will be analysed for 'The Corporate Report-New Horizons' project and should be received by 31 January 2000. Unless a commentator requests confidentiality, comments will be placed on the public record. They can be sent by email to [jparkins@icaew.co.uk](mailto:jparkins@icaew.co.uk) or by post to:

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# Summary

## *Investors' needs*

Investors today want information about a company's potential for creating shareholder value. Value is created by enhancing a company's prospects and this, to a large degree, stems from a company's competitive advantage together with the ability of management to choose and implement a strategy which exploits that advantage.

Annual reports give a primarily historical perspective and provide limited information on these matters. The Accounting Standards Board statement on the Operating and Financial Review (OFR) already recommends the inclusion of a discussion of the main factors that may influence future results, including the principal risks and uncertainties, but the reporting of forward looking information by companies is generally very sparse.

When given the opportunity to question management, it is our experience that analysts and institutional investors are keen to understand a company's strategy and the key 'drivers of value' that must be managed in order to execute that strategy. Questions asked include:

- What is the company's strategic vision and strategy for achieving it?
- Why is that the appropriate direction?
- Does the organisation have the capability to implement the chosen strategy?
- What does management need to manage in order to achieve its objectives?

These are important issues that should be addressed in the annual report. We believe it to be undesirable for the answers to be restricted to those able to attend a briefing meeting. Indeed, companies could benefit by communicating to a wider audience the clarity of management's purpose and the linkage between their strategic direction and their performance.

## *Management's pivotal role*

Many managers believe that a gap exists between the internal perception of a company's potential and that of the stock market. One of the roles of effective management is to act as a bridge between the external world and the company, ensuring that the external perception of a business reflects the way in which the company operates. To do this, management must understand the investment process, and understand investors' valuation models in order to 'speak their language'.

At the same time, implicitly or explicitly, management will have its own business model and will have chosen strategies expected to optimise future performance. Many companies have developed value related measures of performance and lead indicators that reflect progress towards achieving the chosen strategy. The measures and the lead indicators used, at board level, to manage a business are equally important to the stock market in ensuring a fair judgement of the business and reliable forecasts of future returns.

The challenge for management is to link the internal and external perspectives, thus making key aspects of a company's capabilities more transparent to investors. The phrase 'Inside Out' in the title of this paper reflects our belief that management must be more open in the external disclosure of key elements of the information used internally to manage the business.

The future is uncertain and cannot be reported as a matter of fact, but reporting the past alone is no longer enough. We believe that the annual report should be designed with the aim of encouraging managers to report both why their strategies are expected to lead to the creation of value over the long term and their view of performance. These together will enable investors to make their own assessments of the future prospects of a business and take better-informed decisions.

We propose structured, qualitative disclosures, supported by trends of the most important performance indicators and measures used by management. We are aware that commercial sensitivity may impose limitations on the disclosure of forward looking performance measures and targets but we are of the opinion that there remains considerable scope for additional information to be disclosed.

### ***Our recommendations***

Our proposals are relevant to all companies whose shareholders are remote from management. The proposals are, therefore, aimed principally at listed companies.

We believe it is important for explanation of a company's strategy and the progress it is making towards achieving that strategy to be placed within a structured framework. Therefore, we recommend that a listed company should disclose, either in its OFR or in a similar statement, the key features underpinning its internal 'model':

**For the company as a whole:**

- Its ambitions;
- Its strategic direction, together with targets or milestones towards achieving its objectives;
- A description of the strategic decision-making process;
- A description of the performance management process;
- The preferred measures used internally to monitor economic performance.

**In addition to the above, for each significant business activity as identified for management purposes:**

- A description of the key drivers of value in the business, derived from, inter alia:
  - A description of the market in which the business operates, using both qualitative terms and quantitative data;
  - Why management believes it is the right market to be in;
  - The business's competitive position within the market;
  - Future trends anticipated in the market;
  - How management intends to maintain or alter the business's position within the market.
- Measures of performance appropriate to the business, including non-financial measures, and/or lead indicators, derived from the key drivers of value, that are used internally to monitor potential in that business.

We see these proposals as providing a practical framework for the introduction of a more forward looking perspective into annual reports. They should not be considered a theoretical 'wish list'. Our proposals are incremental, building upon and giving a structure to the practice which is already emerging around the world, largely outside the UK. The final section of the paper brings together some examples from current corporate reporting which illustrate the thinking behind our recommendations.

We ask companies to experiment immediately with the additional disclosures we propose. There is nothing radically new in our proposals but putting these disclosures together can present a sharper image and differentiate a company in increasingly demanding capital markets.

The proposals create a link between external reporting and the processes and performance indicators used internally. We believe that this more transparent disclosure will lead to an improved understanding of management objectives and of the risks and opportunities associated with an investment. An improved understanding of the business and management's objectives will permit investors to assess performance against the targets set by management and should, therefore, build management credibility. Better information about the risks and opportunities faced by the company should help investors to value a company more accurately and with less uncertainty, which may reduce capital market volatility.

# 1. The need for shareholder value reporting

This paper starts from the view that the economic value of a business is the present value of its expected future cash flows. The value created by a business is, therefore, best represented by the change in its economic value, that is, the change in the net present value of its expected future cash flows.

However, because the future is uncertain, changes in economic value cannot be captured in a single figure and reported as a matter of fact. The measurement of value created is, inevitably, subjective and a system of financial reporting based upon expectations of future cash flows would not, currently, be thought sufficiently reliable to be widely acceptable.

Many investors do, however, base share valuations on their forecasts of future cash flows and want forward looking information to feed into their valuation models. Capital markets around the world have become more competitive as a result of the removal of restrictions on cross-border flows of capital and improved technology. So, active institutional investors, under 'perform or perish' scrutiny themselves, are today looking for information from companies about their potential for creating value.

The objective of this paper is to stimulate the development of ways of giving this information.

## 1.1. What is shareholder value?

'Shareholder value' has become a widely used cliché but it is, perhaps, not widely understood. This may be because the different measures of shareholder value capture different aspects of performance.

From the investors' perspective, value created is commonly measured as the growth in a company's share price over a period together with dividends received from it, the Total Shareholder Return (TSR). This is an essentially forward looking measure since share prices reflect the market's expectations of future cash flows. If a stock market prices shares efficiently, this will reflect the value created by management in a period.

From management's perspective, the insight offered by a 'value' focus is that the use of equity capital is not 'free', it is invested in the expectation of earning a return and this required return defines the company's cost of equity capital. Management can only create value for shareholders if the company consistently, over the long term, generates a return on capital which is greater than its cost of capital.

Companies can use this value focus both in their strategic planning process and in measuring performance. Forecasts of expected cash flows are commonly used in project appraisal and Total Business Return (TBR) applies this forward looking, cash flow perspective to an appraisal of the performance of a whole company or business. Alternatively, economic profit measures of performance, including Economic Value Added (EVA), are calculated historically. The different measures capture different aspects of performance and there is no single 'right' measure of shareholder value created. Appendix I provides a brief description of the more common shareholder value measures.

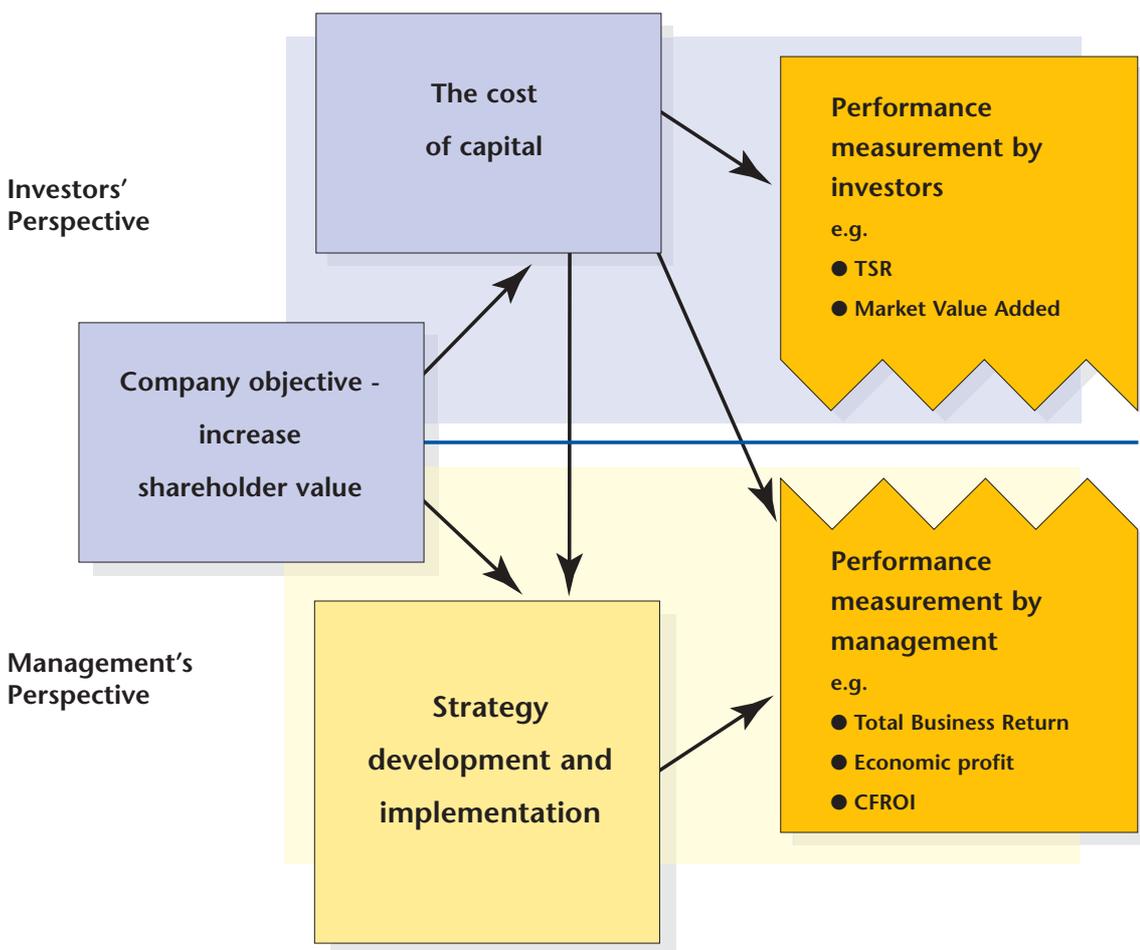
There are other issues too. Share prices react to factors outside the control of management in the short term, for example, the raising of interest rates. Is it right that performance measurement reflects this, as a measure based on share price will? There may, also, be a disconnect between the market's measurement of value, based on share price, and management's view of the value created. A recent survey of 100 UK senior executives by PricewaterhouseCoopers (PwC) found 34% believed the shares of their company to be undervalued and 6% believed them to be overvalued.<sup>1</sup> Share prices are volatile and, while most people accept that the stock market prices shares efficiently in the long term, many believe that it over-reacts to

<sup>6</sup> <sup>1</sup>Reporting Gaps in the UK: *The Chief Executive's Perspective*; R. Eccles, D. Phillips, H. Richards, PricewaterhouseCoopers, 1998.

news in the short term. Furthermore, the estimation of a cost of capital is not straightforward.<sup>2</sup> For these reasons, the measurement of value created is not easy and it is important to look at the creation of value over several periods; whatever the measure used, the trend is as important as its size in a single period.

Figure 1 summarises key elements of the internal and external perspectives on shareholder value creation. While management and investors both measure value created, it is management that creates value by developing and implementing an appropriate strategy that recognises the cost of capital.

Figure 1: Investors' and management's perspectives on shareholder value



## 1.2. Creating shareholder value

In the highly competitive business environment of today, management seeks to enhance future cash flows and create value by recognising and sustaining the company's sources of competitive advantage. Management's ability to develop a strategy which builds on the business's sustainable competitive advantage is a significant factor in the creation of shareholder value. Equally important is the ability to implement that strategy, to recognise and manage the risk inherent in the strategy and to identify future sources of potential competitive advantage, including trends in markets.

<sup>2</sup>Some companies compare the return on net assets with a weighted average of the costs of equity and debt capital (WACC); others compare the return to shareholders with the cost of equity capital alone. Calculation of the cost of equity capital poses a considerable challenge in practice as it relies on a number of assumptions and estimates, chiefly relating to the relationship between risk and investors' required return. An investor requires a return on his investment greater than the risk free rate obtained from investing in government bonds and his required return increases as the perceived risk of an investment increases but the exact relationship is unclear.

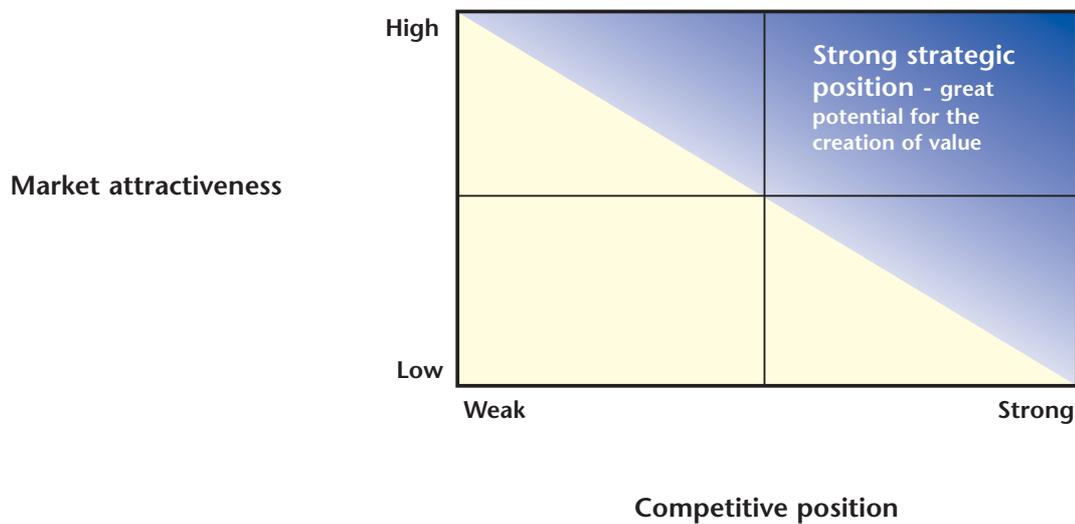
Management has two principal ways to create shareholder value:

- Obtain greater efficiency, either margin or asset, from the existing capital base. This is often referred to as numerator management and denominator management. Numerator management is about improving margins or achieving sales growth from the existing capital base. Denominator management is about asset and cost efficiency.
- Growth, by investing in projects which are expected to generate a return in excess of the cost of capital.

Managing for shareholder value creation has been criticised for emphasising efficiency at the expense of growth.<sup>3</sup> This is a misapprehension, as creating shareholder value need not be primarily about downsizing. An important part of management's strategy must be the search for profitable growth opportunities.

Competitive analysis is a widely used management tool in the search for investment opportunities. It is used to identify markets in which a business has a strong and sustainable strategic position as a result of its sources of competitive advantage. A good strategic position offers great potential and value should be created by additional investment in these markets. Competitive analysis would, typically, examine the strategic position of a business as a combination of the attractiveness of its markets and its individual competitive position within each market, as illustrated in Figure 2. An attractive market is one in which the average business expects to earn a positive return on its investment both now and in the future. The competitive position of a business is derived from the specific sources of competitive advantage of that business which can be sustained over time and exploited in that market.

**Figure 2: Strategic positioning**

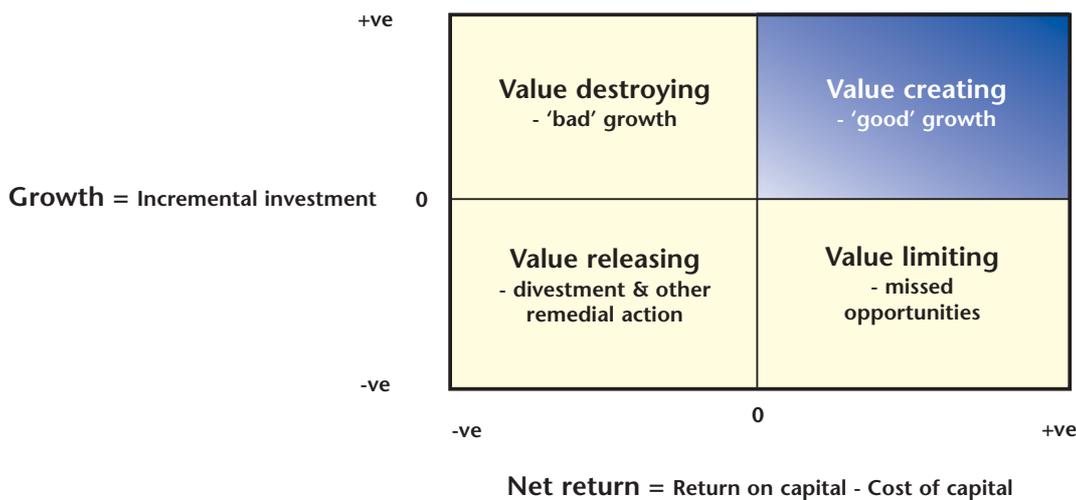


An understanding of the current and likely future strategic position of a business gained from competitive analysis can be used to assess whether participation in a particular market is likely to create value and to assist in the choice between alternative strategies for competing in that market.

The key insight offered by a 'value' perspective is that growth, or incremental investment, will not create value for shareholders unless a return on capital in excess of the cost of capital is anticipated. This is illustrated in Figure 3, where value is created only on the right-hand side of the diagram.

<sup>3</sup>As recently in 'What's driving your share price today?' A.T.Kearney, 1998.

Figure 3: Growth and return



For the management of a business to continue to create value it must have a clear understanding of the strategic position of the business to ensure resources are allocated to value enhancing investment opportunities. Investing in projects that expand the business in markets in which it has a strong strategic position has the greatest potential to create value. Where a business allocates resources to projects expected to earn a return in excess of the cost of capital it will add to the present value of the expected future cash flows and hence to the economic value of the business, creating shareholder value.

### 1.3. Reporting on the creation of shareholder value

Why should companies report on their potential for creating shareholder value? Surely, some would say, it is nothing more than a passing fad.

On the contrary, we believe that the forward looking perspective adopted by management in the strategic planning process, in general, and by a 'shareholder value' focus, in particular, matches investors' desire for long term, future-oriented information.

It has already been noted that an entirely quantitative approach to reporting is not currently, and may never be, practicable. Instead investors look for softer, more qualitative evidence that management has set its sights on achieving more than the market expects, in other words - on creating shareholder value.

In the subsequent sections of this paper:

- We argue that, in its present form, the annual report includes too little strategic and other future-oriented information for it to retain its importance as a source of information for investors.
- We present evidence of investors' keen interest in disclosures about the development and implementation of a company's strategy.
- We emphasise our belief that investors' needs should be the main focus for the annual report.
- We call for management to report more transparently the information used to manage the business.
- We justify our preference for structured narrative disclosures of a company's strategy, supported by a set of performance indicators, within the annual report.

## 2. Limitations of the annual report

Annual reports give a primarily historical perspective and provide limited information about strategic strength or any other future-oriented matters. The financial statements themselves remain focused on past events and financial performance. The Accounting Standards Board (ASB) recognises, in its proposed Statement of Principles for Financial Reporting, that this focus does not provide a sufficiently comprehensive view of performance and prospects and that financial statements need to be supplemented by other reports:

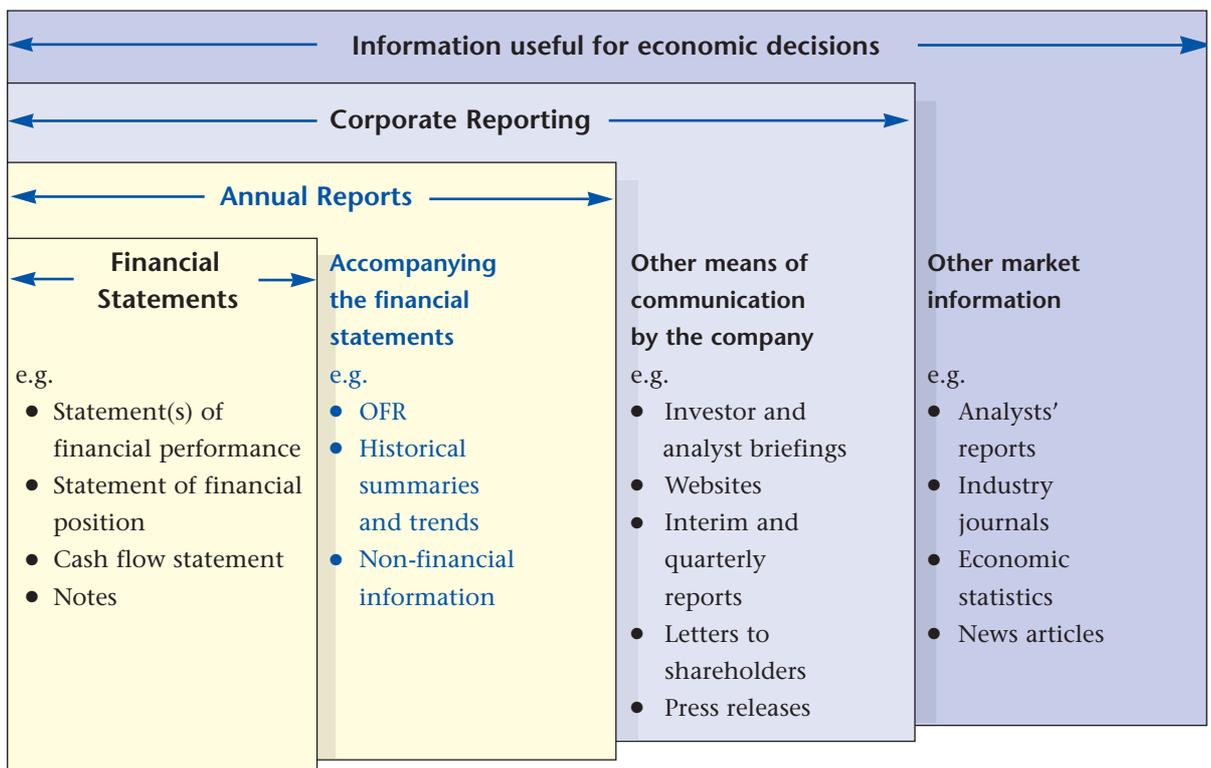
*“Financial statements have various inherent limitations that make them an imperfect vehicle ... for example:*

*...they focus on the financial effects of transactions and other events and do not focus to any significant extent on their non-financial effects or on non-financial information in general.*

*...they provide information that is largely historical and therefore do not reflect future events or transactions that may enhance or impair the entity’s operations, nor do they anticipate the impact of changes in the economic or potential environment.”<sup>4</sup>*

The financial statements form the backbone of an annual report, but they are usually accompanied by other material, principally the company’s Operating and Financial Review (OFR). The annual report is not the only form of external corporate reporting but it has historically been at its heart, as is illustrated by Figure 4.

Figure 4<sup>5</sup> : The communication of decision-useful information



<sup>4</sup>Revised Exposure Draft of the Statement of Principles for Financial Reporting, ASB, 1999, Ch.1 para.1.7-1.8

<sup>5</sup>Developed from the diagram 'Categories of Financial Information' on p.16 of the above Exposure Draft.

The Cadbury Committee highlighted the need for a supplementary, future-oriented report to accompany the financial statements and expressed the hope that the OFR would meet this need:

*“The Committee recognises the advantage to users of reports and accounts of some explanation of the factors likely to influence their company’s future progress. The inclusion of an essentially forward looking Operating and Financial Review, along the lines developed by the Accounting Standards Board ... would serve this purpose.”<sup>6</sup>*

Unfortunately, the OFR has not developed into ‘an essentially forward looking’ operating and financial report. The ASB statement on the OFR recommends the inclusion of a discussion of the main factors that may influence future results. However, surveys of OFR reporting<sup>7</sup> consistently show that companies have been slow to respond to the needs of investors and the challenge of providing forward looking information, both financial and non-financial.

In addition, the emphasis on historical, financial effects is unfortunate because accounting profit is an unreliable indicator of the creation of economic value, especially where significant expenditure that is expected to confer a future benefit is charged against profit in the financial statements. Such ‘revenue investment’ includes spending on brands, research and development, people, knowledge management and innovation.

These limitations are widely acknowledged but the annual report continues to be used by investors despite its shortcomings. So why is change necessary? Chris Swinson, the immediate past President of the ICAEW, gave an answer to this question in introducing a presentation on ‘The 21st Century Annual Report’ when he called for ‘a formal and broad review of corporate reporting’:

*“Why should we now pay more attention to complaints about the usefulness of corporate reports? The answer to this may be that the assets and risks not measured by historical cost accounts appear to be becoming more important as determinants of a business’s future success.”<sup>8</sup>*

Our view is that the annual report must include more information useful to investors’ decision-making or it will become, at best, a secondary source of information.

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<sup>6</sup>Cadbury Report, para. 4.53

<sup>7</sup>Operating and Financial Review: Experiences and Exploration, P. Weetman & B. Collins, ICAS, 1996; What’s the story? Arthur Andersen, 1996 and A Critical Evaluation of Forward-looking Information in the OFR, J. Smith, 1997 dissertation, Heriot-Watt University, Edinburgh. In particular the last of these references reported a pilot study of the 1995 annual reports of ten FTSE 100 companies in which forward looking information averaged only 10% of the OFR.

<sup>8</sup>The 21st Century Annual Report, ICAEW, 1998, p.5

### 3. Investors' needs

The annual report can rarely provide the answers to every question that an investor may ask. However, we believe that the significant gap in the reporting of future-oriented and value based information must be addressed because historical financial information alone is increasingly perceived as lacking predictive value.

We believe that investors place importance on forward looking information in general and information about strategy in particular. Our perception is supported by evidence from recent surveys of investors' needs, which are described in more detail in Appendix II, and by our own experience.

All the surveys confirm both investors' desire for more forward looking information in a company's annual report and the importance to their investment decisions of key drivers of future performance, especially strategy. However, particularly pertinent is evidence obtained from a large scale study by researchers from the Ernst & Young Centre for Business Innovation in the USA<sup>9</sup>. They found that the non-financial information most valued by portfolio managers was information relating to:

- Strategy execution

*"how well management leverages its skills and experience, gains employee commitment and stays aligned with shareholder interests"*<sup>10</sup>

- Management credibility

*which will primarily depend on the integrity of management and its ability to achieve targets.*<sup>11</sup>

- Quality of strategy

*"management's vision for the future, whether it can make tough decisions and quickly seize opportunities, and how well it allocates resources."*<sup>12</sup>

When given the opportunity to question management in briefing meetings, it is our experience that analysts and institutional investors want to look ahead to the opportunities and challenges of the future. They are particularly keen to understand a company's strategy and the key levers, or drivers of value, that need to be managed in order to execute that strategy. Questions asked include:

- What is the company's strategic vision and strategy for achieving it?
- Why is that the appropriate direction?
- Does the organisation have the capability to implement the chosen strategy?
- What does management need to manage in order to achieve its objectives?

These are not, of course, the only questions raised but they are important issues and they could be addressed in the annual report.

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<sup>9</sup> Reported in *Measures that Matter*, Ernst & Young LLP, 1998.

<sup>10</sup> *Measures that Matter*, p.1

<sup>11</sup> These were two of the factors found to be very important to investors in a study conducted by the Institute of Chartered Accountants in Scotland and described in Appendix II.

<sup>12</sup> *Measures that Matter*, p.2

We believe it to be undesirable for the answers to these questions to be restricted to those able to attend a briefing meeting. In this country, it has long been established that factual information disclosed should be equally available to all investors. Indeed, companies could benefit by communicating to all users of the annual report the clarity of management's purpose and the linkage between its strategic direction and performance.

Some companies recognise this and make statements about strategy and objectives in their annual reports that go some way towards dealing with the issues, as illustrated by the examples of existing disclosures in the final section of this paper. But such disclosure is not common and is usually restrained or fragmented.

This does not mean that we are opposed to briefing meetings, just that we believe that these issues are too important to be reported only to a minority of shareholders because companies simply do not have the resources to meet all those with a legitimate interest in the information. The disclosures that we propose are intended to improve investors' understanding of a business, enabling briefing meetings to become more of a dialogue, with feedback given to management by investors.

To summarise, the evidence from recent surveys supports our experience of investors' needs. We therefore consider it vital that external corporate reporting reflects the long term future-oriented perspective, often shared in briefing meetings, between some investors and management.

## 4. A 'stakeholder' perspective?

Some have called for the annual report to adopt a 'stakeholder' rather than a 'shareholder' perspective.<sup>13</sup> In its review of company law<sup>14</sup> the Department of Trade and Industry (DTI) referred to this as the 'pluralist' approach. A contrast was drawn with the 'enlightened shareholder value' approach and views were sought on which approach should now be enshrined in company law. We prefer the 'enlightened shareholder value' approach. We believe that adopting as a company's governing objective the creation of wealth, or value, for its investors is, in principle, also the best way of securing overall prosperity through economic growth and international competitiveness.

However, adopting this objective for a company does not mean that the needs of other stakeholders can be ignored. Critical to this definition of shareholder value is a forward looking perspective which requires the company to build long term relationships to succeed, as the DTI notes:

*"Very often [co-operative and long term] relationships are important ingredients of success. Relationships founded on mutual trust make it more likely that employees will acquire high levels of skill and knowledge. Similarly suppliers will make investments in plant geared to the needs of a particular customer. Such relationships between the company and its customers also lead to stable and efficient markets downstream in the supply chain."*<sup>15</sup>

In many cases, some or all of the other stakeholders will be critical to the success of a business and it will only be by meeting the needs of those stakeholders that a company will create the greatest shareholder value. A survey of 20 listed companies has provided some evidence that companies which adopt an 'enlightened shareholder value' approach do value their long term relationships with all stakeholders and also, therefore, rank well in terms of the 'stakeholder' value they create.<sup>16</sup>

Because we believe that the creation of shareholder value is the appropriate objective of a company, we believe that external reporting should continue to focus on investors' information needs.

Another, commonly expressed, reason for preferring to report primarily for shareholders is that, by providing equity capital, investors take the greatest risk and, therefore, require the greatest level of detail about the company. So information designed to meet their needs is also likely to meet many of the needs of other stakeholders. We believe that this too continues to be true.

<sup>13</sup>For example the Royal Society for the Encouragement of Arts, Manufactures and Commerce project *Tomorrow's Company*.

<sup>14</sup>In *Modern Company Law for a Competitive Economy: Strategic Framework*, DTI consultative document, para.5.1.12, 1999.

<sup>15</sup>From the same document para. 5.1.10

<sup>16</sup>Reported in *Shareholder Value*, I. Cornelius & M. Davies, FT Financial Publishing 1997, pp.199-204.

## 5. Management's pivotal role

Many managers believe that a gap exists between the internal perception of a company's potential and that of the stock market. Management has a pivotal role to play in the communication process, acting as a bridge between the external world and the company, to ensure that the external perception of the business reflects the way in which the company is positioned and operates. Implicitly or explicitly, management will have a model of business performance and will have chosen the strategies it believes most likely to achieve optimum levels of future performance, based on that model. To implement the strategy management must understand the internal processes and performance drivers and operate in that 'language'. However, to communicate effectively with the external world management must also understand the investment process and investors' valuation models in order to be able to 'speak their language'. The key, in our opinion, is greater transparency in the external reporting of internal processes and measures.

We are therefore proposing the disclosure only of information already available to management. In today's global markets, management need to be able to meet the challenges of greater competitiveness in both capital and customer markets and be in a position to take advantage of potential world-wide opportunities. Successful companies usually focus on where they want to be and how they are going to get there, rather than where they have been. So, typically, managers no longer rely on a small number of historical, financial measures to manage their company. Increasing emphasis is placed on forward looking strategic processes and measures useful in monitoring progress towards the successful implementation of a strategy. These are likely to include both leading indicators of financial performance and non-financial measures.

### 5.1. Strategy development

The process of developing strategy is more formalised in some companies than others but the same questions usually need to be addressed:

*"The first stage is the selection and analysis of all relevant information: What is our current situation? How do we seem to our customers? How do we stand competitively? Do we see trends - and if so, in which direction? ...*

*Then: What is possible for the future? What is our most desirable (practical) destination? ...*

*And then finally: How do we get there? What actions, deeds, changes, inventions, investments do we need to make that will make our arrival at that destination most probable?"<sup>17</sup>*

It is impossible to be successful long term without a view of the future direction to be taken by a company. A focus on strategy is, therefore, vital to the management of a company and recent research shows it to be of significant importance to investors.

Fundamental to an assessment of a company's strategic position is a review of the market place and its positioning within that market vis-à-vis competitors. This information is vital to an understanding of a company's ability to compete and create value in the future. While many investors undoubtedly perform their own competitive analysis, we believe that they also want to understand the options considered by management and the rationale underlying management's choice of strategy.

<sup>17</sup>Edited from an essay *Why we exist: Time-and-Motion Man and the Mad Inventor* by Jeremy Bullmore, included in the 1998 Annual Report and Accounts of WPP Group plc at p.18.

## 5.2. Performance indicators

But a strategy does not exist in a vacuum. The choice of strategy will both affect, and be affected by, the key drivers of value of a business – those areas in which a business must perform well for its strategy to be successfully implemented. Many businesses have developed performance indicators to monitor their progress towards achieving their chosen strategy.

Performance indicators are, as the name suggests, intended to give early indications of performance rather than measure performance itself. The financial measures of sales growth, profit margins and capital investment will be important lead indicators of performance for all businesses; but many businesses also use other measures, derived from their specific value drivers and individual circumstances.

For example, a company operating in a new and developing market will probably have identified a strategy of market penetration as likely to create the most value. In this case, the key process is marketing and the indicators used to manage the business could include measures of market growth, market share and customer acquisition.

Another business, manufacturing products to sell in a very competitive, mature market, may choose a strategy of being the lowest cost producer. The purchasing of raw materials and the manufacturing conversion may then be the processes that drive value and the performance indicators used would focus on the critical aspects of those processes, perhaps monitoring input price inflation, asset utilisation and employee productivity.

Appendix III provides some examples of performance indicators. Some of the performance indicators provide information about ‘assets’ that are hard to quantify such as the efficiency of a company’s processes or intellectual capital. Others are lead indicators of either external or internal conditions, for example:

- a prediction of market growth;
- the trend in customer retention; or
- an indicator of employee morale such as the trend in employee turnover.

Investors’ primary interest is in a company’s ability to produce value in the future. Their main concern with traditional accounting based measures is their lack of predictive power. However, the primary reasons for this perceived deficiency are the same as those which have led management to use a more extensive set of performance indicators. The needs of investors and management, therefore, overlap to a considerable degree and indicators that are used internally are equally important to the stock market in making a fair judgement of the business and forecasts of future returns.

A business may use a wide range of performance indicators internally for different levels of management. We propose the disclosure only of those monitored at board level as the key measures. We do not believe this would be too onerous. For example, for Jack Welch of General Electric Inc. there are three key measures to track:

*“The three most important things you need to measure in a business are customer satisfaction, employee satisfaction and cash flow. If you are growing customer satisfaction, your global market share is sure to grow too. Employee satisfaction gets you productivity, quality, pride and creativity. Cash flow is the pulse – the vital sign of life in a company.”<sup>18</sup>*

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<sup>18</sup>Quoted in *Performance Measurement: The New Agenda; Using Non-financial Indicators to Improve Profitability*, J. Geanuracos and I. Meiklejohn, 1993, p.6.

In addition to using performance indicators, companies are increasingly monitoring underlying, or economic, performance using one or more of the shareholder value measures described in Appendix I. We encourage the external disclosure of these measures where they are believed to be important measures internally.

The challenge for management is to link the internal and external perspectives thus making key aspects of a company's capabilities and underlying performance more transparent to investors. The phrase 'Inside Out' in the title of this paper reflects our belief that management must be more open in the external disclosure of key elements of the information used internally to manage the business.

## 6. Reporting performance – past and potential

In January 1999, the ICAEW published a paper on reporting performance<sup>19</sup> to encourage people to think beyond current financial statements to how performance might be reported. The paper described six possible ways of measuring financial performance. Any historical measure of performance will not capture the effect of actions and decisions already taken whose financial effect lies in the future. The paper therefore concluded that the underlying performance of a business is most completely represented by the change in its economic value, i.e. the change in the net present value of its expected future cash flows. A few companies have begun to experiment with use of this kind of measure internally. However, because the future is uncertain, the calculation inevitably involves a higher degree of subjectivity than is, currently, likely to be acceptable for an external financial reporting system.

When ‘performance’ incorporates expectations about future events, it cannot be reported as a matter of fact and cannot, therefore, be perfectly captured within a single measure. Our preference is therefore for the annual report to include, not a single measure of shareholder value created, but a set of data, supported by structured narrative disclosures from which investors and their advisors can draw to meet their own individual needs. Our preferred approach is for the historical cost financial statements<sup>20</sup> to be supplemented with future-oriented reporting which reflects a long term perspective.

We propose structured qualitative disclosures about the nature of a company’s strategic and performance management processes and its position within the markets in which it operates. These should be supported by trends in any value based performance measures used by management and those performance indicators identified by them as relating to the key value drivers for their business.

We are aware that there will be some information that management believes to be too commercially sensitive to disclose either because it would damage a business’s competitive advantage or because it could prejudice the outcome of a future event. It is for management to decide upon the extent of additional disclosures. However, in exercising their judgement, we ask that they do not consider only the potential costs of disclosure but weigh against that the benefits that increased transparency can offer, either directly through an improved relationship with investors, or indirectly as a result of competitors’ disclosures. We are of the opinion that there remains considerable scope for additional information that is useful to investors to be disclosed. In particular, we believe that factual disclosures made in analyst and investor briefing meetings should be incorporated into the annual report.

We are also aware that, in asking for disclosure about processes, there is a risk that the disclosures made may become the standardised, non-specific and uninformative statements known as ‘boilerplate’. However, we believe that investors will place little value on such statements. Further useful disclosure is possible and we believe the market will reward those companies able to demonstrate that they have a clear strategic vision and the capability to implement it effectively.

We are not proposing the disclosure of detailed profit or cash flow forecasts but recommend that companies should make some predictive statements, for example, the expected growth in the market for its products over the next three years. Companies will be aware of the need to guard against the making of over optimistic predictions and, to promote balance, we encourage companies to report back against the predictions previously made in a company’s annual report.

In addition, we recommend that forward looking and predictive statements are identified as such and that the nature of such statements is made clear. UK companies with a US listing will already incorporate a cautionary statement in their 20-F report, in order to come within the US ‘safe harbour’ legislation. We do not propose such legislation for this country, but a cautionary statement would still be appropriate to clarify the nature of prospective information.

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<sup>19</sup>*Financial performance: Alternative views of the bottom line*, ICAEW, January 1999

<sup>20</sup>We acknowledge that current values are already incorporated into a balance sheet for certain assets - but the focus of the financial statements remains historical.

## 7. Our recommendations

Our recommendations start from the view that management should report more transparently to investors on the foundations of their business model, in particular, management's strategy and the key indicators of successful implementation of that strategy. We believe that our proposals are relevant to all companies whose shares are, primarily, held by those not involved in the management of the company or represented on its board. The proposals are, therefore, aimed at listed companies but would also be appropriate for private companies with shareholders remote from management.

The proposals are intended to provide a framework for explaining a company's strategy, and the progress that the company is making towards achieving that strategy. As narrative disclosures and non-financial measures form an important part of our proposals we believe that the appropriate place for these disclosures is in a company's Operating and Financial Review, or in a similar statement.

Our proposals are based upon disclosures relating to:

- **Strategy;**
- **Markets and competitive positioning;**
- **Key performance indicators and 'value' based measures of performance.**

In presenting this information, we believe it to be essential that companies report in a structured way, demonstrating how these elements relate to and/or are derived from each other.

We propose that a company make the following disclosures, both for the company as a whole and, in addition, for each significant business activity of the company:

- **Describe the strategic ambitions.**

We recognise that a company with diverse businesses may only be able to express its ambitions as a numerical target. This overall goal would, usually, be translated into one or more specific objectives for each business activity and we would expect a more detailed description to be possible at that level.

- **Indicate the strategic direction, together with targets or milestones towards achieving its objectives.**

We are asking for disclosure of how management intends to achieve these ambitions. Some companies already disclose this information for the company as a whole. However, it is difficult to assess the overall corporate strategy without an understanding of the alternatives available and the strategy adopted by the individual business activities. We, therefore, go beyond recommending disclosure of the corporate strategy and propose both disclosure of the strategies adopted by significant business activities and information relevant to the choice of that strategy.

- **Describe the strategic decision-making process.**

Although it can be difficult to avoid standardised statements when describing a process we believe that there are differences in the way companies or business activities operate which can usefully be disclosed. These include the degree of decentralisation of strategic decision-making and the way in which companies ensure that the strategic direction of individual business activities is consistent with the corporate strategy.

- **Describe the performance management process.**

Performance management incorporates but is not limited to performance measurement. Performance management seeks to ensure that a business delivers the planned performance or, where actual performance diverges from plan, action is taken to change either the strategy or the planned performance. As part of this process performance measurement seeks to identify and monitor the most appropriate intermediate measures for managing a business. In addition, performance measures are increasingly used to align managers more closely with shareholders' interests through performance related incentive schemes.

We propose that a company describes its performance management process and, as companies move away from traditional accounting based performance measures to manage a business, we believe it will be helpful to disclose how the performance measures monitored are developed from and align with the corporate strategy or that of the business activity.

Incentive schemes for senior management are, usually, already well documented in a company's annual report. We are not proposing any additional disclosures except that it would be helpful if management could indicate links between an incentive scheme and the key drivers of shareholder value.

- **Provide a calculation of the preferred measures used internally to monitor economic performance.**

Most businesses will use shareholder value measures to some extent. For example, the use of discounted cash flow analysis in project appraisal is widespread. Any value based measure depends upon an estimate of the cost of capital, either to calculate the measure or as a comparator. Where any value based measure is used internally, we recommend disclosure of a management estimate of the cost of capital, together with the principal elements of the calculation. It would also be helpful for a company to indicate whether management believes its current financial structure to be appropriate and, if not, the target gearing.

As indicated in Appendix I, there are a number of different shareholder value measures which capture different aspects of performance. Where one, or more, of these measures is important to management, we recommend that it is disclosed externally, together with sufficient detail for the calculation to be reconciled to the financial statements, if the measure is derived from those statements, or any other supporting detail needed for a proper understanding of the measure.

Whatever the measure used, the trend is as important as its size in a single period. Consequently, where management has the information available, we propose that a five year trend is reported, calculated on a comparable basis.

In addition to the above, we propose the following disclosures for each significant business activity:

- **A description of the key drivers of value in the business activity**

The key value drivers are those processes or factors that are critical to the creation of value for the strategy adopted by a business activity. The choice of strategy is likely to have been influenced by an analysis of the market place and the business's competitive position within that market. Therefore, we recommend that a company provide:

- A description of the principal market in which the business operates, using both qualitative terms and quantitative data;
- An explanation of why management believes it is the right market to be in;
- A description of the business's competitive position within the market;
- A prediction, in general terms, of the likely future trends anticipated in that market;
- A statement of how management intends to maintain or alter the business's position within the market.

Although this disclosure is likely to be most informative at the level of a business, we recognise that, for companies with a considerable number of significant businesses, it is likely only to be practicable at the level of a business activity as identified for management purposes.

- **Measures of performance appropriate to the business, including non-financial measures, and/or key lead indicators, derived from the key drivers of value, that are used internally to monitor potential in that business.**

Again, we recommend that the trend in a performance indicator or measure is shown over five years and that sufficient supporting detail is provided for a proper understanding of the measure used. We do acknowledge, however, that the measures monitored internally will change over time and we would not expect a company to disclose a value for a measure for a period during which it was not regarded by management as an important internal measure.

We see these proposals as providing a practical framework for the introduction of a more forward looking perspective into annual reports. They should not be considered a theoretical 'wish list'. Our proposals are incremental, building upon and giving a structure to the practice which is already emerging around the world, largely outside the UK. The final section of the paper brings together some examples from current corporate reporting, which illustrate the thinking behind our recommendations.

## 8. Examples from current reporting practice

In this final section we bring together some examples from current corporate and public sector reporting to illustrate our proposed disclosures. We cannot illustrate all our recommendations from the annual report of any one body but many companies provide some of the disclosures we suggest. These examples are not intended as templates to be copied but should, rather, be seen as an indication of the route we propose.

We ask that a company:

- Describes its strategic ambitions;
- Indicates its strategic direction, together with targets or milestones towards achieving its objectives.

Many companies already state their strategic ambition, but we believe that the usefulness of this disclosure is greatly enhanced by linking the ambition to the direction a business intends to take and by providing targets or milestones against which subsequent achievement can be monitored.

In these extracts, from the Cadbury Schweppes 1998 Annual Report, clear statements are made about the company's overall objective, its business philosophy, the long term targets management has set itself and the strategic direction pursued in each of the business segments. In addition, performance against target is reported for the three year period since the introduction of those targets.

### Managing for Value

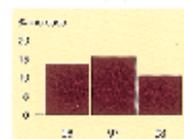
Our primary objective is to grow the value of the business for our shareowners.

**Managing for Value** is the business philosophy which unites all our activities in pursuit of this objective.

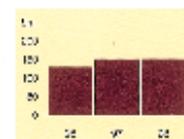
The objective is quantified. We have set three financial targets to measure our progress:

- 1 to increase our earnings per share by at least **10%** every year
- 2 to generate **£150 million** of free cash flow every year
- 3 to **double** the value of our shareowners' investment within four years.

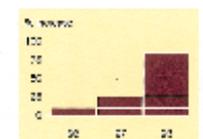
Our approach to this task is holistic. We seek simultaneously to develop better strategies, upgrade our business culture and align our reward structure with the interests of our shareowners.



Underlying Earnings per Share  
To deliver our 10% target  
annual (All currency costs are  
inflation adjusted, using the multiplier  
42/104)



Cash Flow  
To generate £150 million per year  
cash flow



Cumulative Total Shareholder  
Return  
To double investment in value within  
4 years (ICM 1998 to 2000)



**Group Strategy**

The Group's governing objective is to maximise growth in shareholder value. In pursuit of this goal, its strategy is based on competing in the two growth markets of global confectionery and US beverages with strong brands which earn high margins and generate substantial cash flows. The Group intends to grow profitable volume and market share by innovation in products, packaging and route to market, by development through value enhancing acquisitions and by creating an organisation focused on the principle of "striving for value".

**Business Segments**

The Group's business is divided into two product streams: beverages and confectionery.

**Beverages Stream**

In beverages, the Group's strategy is to develop and expand the markets for its various brands by using the most efficient and value creating route to market. This may take the form of licensing agreements, partnership arrangements or company owned bottling operations.

**Confectionery Stream**

In chocolate and sugar confectionery, the Group's strategy is to build strong positions in profitable markets through internal growth and value enhancing acquisitions. In addition, the Group seeks to identify cost reduction within its operations and implement it, across the sector, to realise efficiencies and enhance competitiveness.

**Strategic value developments**

The key to driving profitable growth in the US, the world's largest soft drinks market, is to align our business with those bottling systems which can offer security and growth for our brands.

Nearly 50% of Dr Pepper and Schweppes volume is licensed to Coca-Cola and Pepsi aligned bottlers. In 1998 we took steps to strengthen distribution and growth opportunities through:

- An extension of our licensing agreement with Coca-Cola Enterprises, the predominant Coke bottler in the US
- A multi-year bottling agreement with the Pepsi Bottling Group, Pepsi's largest US bottler
- Our investment, with a partner, to create The American Bottling Company brought together three independent Midwest bottlers to form the largest independent bottling company in the US with sales of nearly US\$1 billion.

**Growing our business**

Acquisitions that generate value are important to our strategies for profitable growth. We apply rigorous criteria to ensure we only make acquisitions based on a thorough understanding of the attractiveness of a market and where our brands have clear competitive advantage.

Poland has one of the strongest economies in Central and Eastern Europe. Between 1990 and 1997 the Polish chocolate market grew at an average of 17% p.a. and it is one of the largest moulded chocolate markets in Europe. Our acquisition of its leading chocolate brand, Wedel, fits well with Cadbury Poland and gives us a strong leadership position across all chocolate segments.

Established in Poland for over 147 years, Wedel is widely regarded as a national icon. Synonymous with a great taste, Wedel, together with Cadbury Poland, provides a platform to identify other opportunities to create value in the developing Central European markets.

We commend the clarity of the reporting of Cadbury Schweppes of its targets for the company as a whole and the reporting back against those targets. However, we would also like to see the overall target linked to the targets for individual business segments, as in the following extracts from the 1998 Annual Report of the Swedish company, Ericsson.

In the first extract the company states its growth target for each segment and relates the overall target, of 20% annual growth, to targets for other financial indicators. The second extract gives the target market position for each business segment and growth expectations for markets within those segments.



As overall objective the Ericsson is to ensure competitive value growth for its shareholders. This covers the collective development of Ericsson shares and dividends to Ericsson shareholders, which are measured in Ericsson share. Competitive value growth means that none of the Ericsson share is among the best in a comparable group of companies.

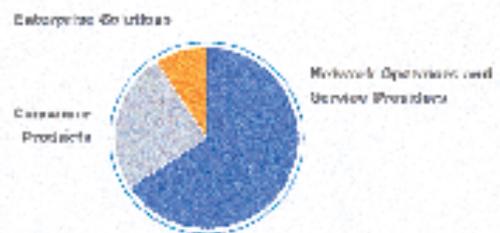
**Growth target**

It is the company's objective to grow faster rapidly than the market, which involves long-term growth of at least 20 percent annually. This growth objective covers three to five years, since the company estimates that certain growth markets, particularly mobile data communications, will not gain pace until the next century. The general objective will be achieved by concentrating on improving positions in certain specific segments. In the Business Segment Network Operation and Service Providers and Consumer Products, growth will exceed 20 percent. In the Business Segment Enterprise Solutions, growth of 10 to 15 percent is expected, while it is estimated that other company units (Defense Systems, Components and Cables) will grow by 10 percent annually.

**Cash flow and capital turnover**

Ericsson strives to have positive cash flow before strategic acquisitions. Growth of at least 20 percent with a positive cash flow requires a yield on capital employed of 20 to 25 percent on balance as a whole. Consequently, there is a need for average operating margins of 10 percent on assets and an average capital turnover rate of two or better. However, the return requirement may vary for different segments. A lower operating margin can be offset by a higher rate of capital turnover. All of the various units - Business Unit, Product Line and Market Area - have a distinct profit responsibility. This means that each unit, apart from responsibility for profit, also bears responsibility for their share of capital employed.

Net sales in 1998 by Business Segment



Long-term growth targets

	Sales growth, %
Network Operations and Service Providers	>20
Consumer Products	>20
Enterprise Solutions	10-15
Other	10
Ericsson	>20



Wanted Position

Telco's dynamic development provide the background to Ericsson's long-term growth objective to increase sales by more than 30 percent per year, a rate that exceeds average growth. The growth objective extends over a period of three to five years.

Total market value in the New Telecomm World is estimated in the range of USD 275-320 billion (1997). Forecasted major sales include networks, equipment and related telecomm services as well as datacom activities. However, it does not include the traditional IT activities of computer companies.

Ericsson's growth will be determined by its ability to defend and advance its positions in different markets. The goals that Ericsson is striving to achieve within three to five years, and anticipated annual growth in the market during the same period, are presented below.

Business Segment: Network Operators and Service Providers

(Formerly Business Area: Mobile Systems and Telecomm Systems)

- Maintain market position as No. 1 in mobile telephone. Annual market growth is estimated at 15 percent.
- Establish position as No. 1 in wireless data transmission. Projected annual market growth is extremely high. This objective should be viewed in a somewhat longer perspective, when key growth sectors such as mobile data develop.
- Defend present position as one of the market's three largest companies in wireline voice telephony. Projected growth in this mature market sector is expected to total about 3 percent annually.
- Establish niche position among top three market leaders in wireline data based on premium real-time transmission. Anticipated market growth: 20 to 25 percent.

Business Segment: Corporate Products

(Formerly Business Area: Mobile Phones and Terminals)

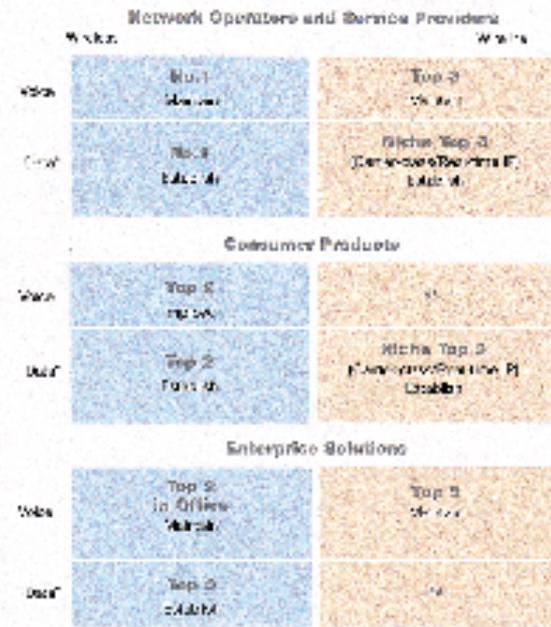
- Strengthen market position and strive to become one of the two leaders in wireless world. Projected world market growth is about 10 percent.
- Establish Ericsson as one of the two leaders in wireless data transmission, a sector with projected annual growth of nearly 40 percent.
- Establish niche position among the two key players in wireline data based on premium real-time transmission. Anticipated annual market growth is very high.

Business Segment: Enterprise Solutions

(Formerly Business Area: Business Area: Mobile Systems and Telecomm Systems)

- Defend a leading position in wireless world telephone, a sector with projected annual growth in excess of 10 percent, and establish a position as one of the two largest companies in the office equipment.
- Establish Ericsson as one of the market's three leaders in wireless data, a sector with projected annual growth of about 30 percent.
- Defend position as one of the market's five leading companies in wireline data, a sector with projected growth of only 3 to 5 percent annually.

Wanted Position



- Ericsson's position: Blue, G.P.  
- Competitor's position: Orange

We ask that a company:

- Describes its strategic decision-making and performance management processes.

There is little current disclosure about these processes. However, the following extracts from the 1998 Annual Report and Accounts of Stakis do give some clues.



We place a great deal of emphasis on generating cash and reinvesting it. Managers at all levels are encouraged to create high return projects and enter these in an internal competition to ensure that funds are

channelled to the projects with the highest internal rates of return. All projects are subject to a post-completion audit to ensure that returns are as expected and that lessons are learned. We do not claim that this is rocket science, but we do claim that we do it diligently, that it avoids under-performing investment and that it does drive growth. ... We make investments with internal

rates of return in excess of our 10.5% hurdle rate. ... In making capital expenditure and acquisition decisions we routinely forecast our results and cash flows for the current and following two financial years to indicate the impact upon our financing ratios of the investments being considered.

This, rather general, extract from the 1998 Annual Report of Skandia gives some indication of the scope of its new Navigator model and IT system.



Starting in 1999, Skandia no longer prepares a budget at the group level. Instead, the group uses the Navigator concept - developed internally at Skandia - for its business planning.

Through use of the Navigator, the group's planning work is widened to encompass the five focus areas of the Navigator:

- FINANCIAL FOCUS
- CUSTOMER FOCUS
- HUMAN FOCUS
- PROCESS FOCUS
- RENEWAL & DEVELOPMENT FOCUS

Through this approach, consideration is given to historical data as well as to the current situation and future outlook in every planning process. The Navigator creates conditions for continuous planning based on a moving follow-up. Time-consuming budget work has thereby been replaced by a real-time planning process. This creates flexibility and adaptability. Less time is spent following up activities and more can be used for future-oriented action.

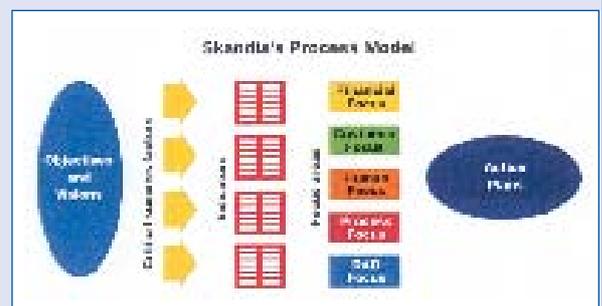
In addition to the five focus areas, each Navigator includes a process model that is built upon *Objectives and Visions* through *Success Factors* and *Indicators to Action Plans*.

## - The Navigator

First-class data support is needed to make the Navigator the effective real-time tool that we are striving for. Toward this end the Dolphin system has been developed internally within Skandia. Dolphin is an IT system that became available to all Skandia employees in October 1998 on Skandia's intranet. Dolphin provides a platform for the various Navigators within the group, giving the employees concerned immediate access to updated planning material.

In Dolphin we have created the conditions for a new structure for development, knowledge-sharing and strategic analysis.

Today every business unit and subsidiary in Skandia has its own Navigator. The system enables the creation of process models and Navigators on the individual level, and the goal is to broaden the concept so that every Skandia employee will have his or her own personal Navigator.



We ask that a company:

- Provides a calculation of the preferred measures used internally to monitor economic performance.

The measure of group performance preferred by the Boots Company PLC is long term total shareholder return. In this extract from the Report and Accounts for the year ended 31 March 1998 Boots states the time period over which the calculation is made, indicates the basis of the calculation, and lists, on that basis, the total shareholder returns of comparator companies.



**Performance measurement** The company's governing objective is to maximise the value of the company for the benefit of its shareholders.

In line with this we believe that the best overall measure of group performance is total return to shareholders calculated from the movement in the share price and the value of dividends as if reinvested when paid. We monitor our performance on a rolling five year basis against ten peer companies, the results of which are shown in the adjoining table.

**Shareholder returns of The Boots Company compared with peer companies**  
Returns are calculated using average share prices over the three months to 31st March.

Five years to 31st March 98		%
1	SmithKline Beecham	287.4
2	Tesco	151.9
3	GUJ	129.5
4	Boots	128.2
5	Kingfisher	117.6
6	Marks & Spencer	100.4
7	Reckitt and Colman	96.1
8	Smith & Nephew	37.3
9	W H Smith	3.7
10	J Sainsbury	6.8
11	Sears	(35.6)

The German Metallgesellschaft Group prefers a calculation of economic profit. In this extract from its website the company states its cost of capital, gives its definition of return on capital and shows how both the numerator and denominator are derived.



**Key figures and control indicators of the Metallgesellschaft Group**  
in million DM

		1997/98	1996/97
<b>EBIT</b>	- Income before taxes	311	324
	- Gross interest expense	210	274
	- EBIT	50	50
<b>Capital employed</b>	- Fixed assets	2,207	2,000
	- Cash and cash equivalents	4,617	4,575
	- Advances to companies, 100% owned (net)	3,755	4,383
	- Receivables	1,398	1,208
	- Other assets	366	450
	- Financial assets	1,561	1,330
	- Trade accounts payable	1,289	1,060
	- Provisions for supplier		
	- Provisions for customer	270	187
	- Capital employed	4,968	4,770
<b>ROCE</b>	- EBIT / Capital employed	12.7%	12.1%
	- Cost of capital (weighted average)	10.8%	11.7%
Cost of the after-tax financing		6.4%	6.5%
<b>WACC</b>	- Weighted average cost of capital	7.8%	8.0%
<b>Value margin</b>	- (ROCE - WACC)	4.9%	4.1%
<b>Economic Value Added</b>	- Value margin x Capital employed	243	198

And in addition to the above, for each business activity, we ask for:

- A description of the key drivers of value in the business, derived from:
  - A description of the market in which the business operates, using both qualitative terms and quantitative data;
  - An explanation of why management believes it is the right market to be in;
  - A description of the business's competitive position within the market;
  - A prediction, in general terms, of the likely future trends anticipated in that market;
  - A statement of how management intends to maintain or alter the business's position within the market.

The following extracts are taken from the 1998 Annual Report of SCA, a Swedish company in the paper products industry, and relate to its hygiene products segment. The key drivers of value for the segment are identified as continuously updating the segment's products and expanding its business, being a low cost producer and being able to offer both branded and retailers' own label products. A good description of the segment is provided, with the principal markets identified and quantified and predictions are made about expected market growth. Indications are also given about competitive position, although the disclosures could be more complete. Good use is made of charts, for example, to indicate the maturity of the market for each of the principal product groups and the company's market share.



The Hygiene Products business area is one of Europe's leading manufacturers of tissue and fluff products for personal hygiene and other applications. The tissue products include kitchen towels and toilet paper, handkerchiefs and napkins. The range also includes tissue for personal hygiene and for wiping and cleaning applications in industry, commercial companies, hotels, restaurants and institutions - known as the Away From Home (AFH) market. The fluff products comprise incontinence products, feminine hygiene products and baby diapers. The business area's customer groups consist of the retail trade (sales to private consumers), the AFH market and the market for incontinence products.

SCA is continuously launching new products as a means of strengthening its competitiveness.

To meet market demand, SCA sells products under its own brands as well as under private labels - retailers' brands.

The business area has sales in more than 40 countries, with Europe being its principal market. SCA is a world leader in incontinence products and is Europe's second-largest supplier of tissue.

#### **MARKET**

The world market for absorbent hygiene products amounts to nearly SEK 400 billion in the production chain, of which Europe accounts for one third.

Sales of tissue and fluff products in Europe amount to approximately SEK 65 billion and SEK 55 billion, respectively. The growth for tissue products amounts to approximately 3% annually. Among the fluff products, there is a strong 10% growth in incontinence products. Sales of baby diapers are rising sharply in Central and Eastern Europe, while demand is increasing only slightly in Western Europe. The same situation applies in the case of feminine hygiene products.

Such American producers of hygiene



products as Procter & Gamble and Kimberly-Clark market their products mainly under their own brands. Fort James, like SCA, sells its products under its own brands and under retailers' private labels. New, higher-quality products are being introduced continuously and constitute an increasingly important competitive weapon.

Up to now the financial uneasiness throughout the world has had a limited impact on sales of hygiene products. Demand in Russia has declined, however, while markets in Asia and South America are relatively unaffected. The growth in sales of hygiene products in these less developed markets is expected to be substantial in the future.

**Retail trade**

Sales to consumers in Europe of such hygiene products as tissue and feminine hygiene items, as well as baby diapers, are made to a large extent via retailers. Equal amounts of tissue products are sold under the manufacturers' brands and the brands (private labels) of retailers. Private labels account for 20% of the sales of baby diapers and feminine hygiene products. The total retail market is valued at SEK 90 billion. Growth is relatively slow, approximately 2% per year.

A concentration and internationalization is taking place among the retail chains. The chains have a growing interest in selling high-quality hygiene products under private labels.

The retail trade outside Europe and the United States is more fragmented. Brand name products are showing strong growth in these areas.

**AFH market**

The principal items sold in the AFH market are tissue products used in industrial and commercial companies, hotels and restaurants, health-care institutions and other public establishments. These products are distributed via wholesalers and service companies or directly to individual customers. The market in Europe is valued at approximately SEK 25 billion. The growth amounts to approximately 3% per year.

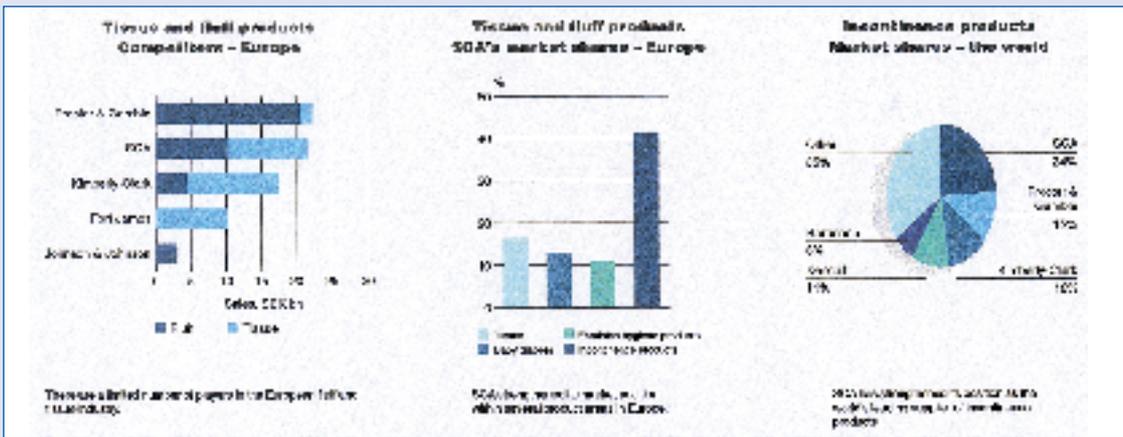
Hand wiping products, along with toilet paper, are the dominant products. The tissue products for hand wiping products are taking market shares from other drying systems such as those employing hot air and textile hand towels.

Important competitive advantages include offering customers a complete concept of installation-ready paper products (paper and holder, etc.) along with good service and deliveries.

**Market for incontinence products**

Incontinence products used in health care and nursing facilities are distributed directly to hospitals and nursing homes, as well as via pharmacies or the retail trade, depending on the health insurance system in the individual country. The products provide protection for light and heavy incontinence.

Sales in the markets in Western Europe and North America amount to approximately SEK 10 billion in each region. The growth, on average, amounts to between 8% and 10% per year. Growth in regions of Southeast Asia and South America is higher. In Western Europe, sales of products for light incontinence are being made through more and more channels and the annual growth amounts to 20%. The total potential throughout the world is substantial, since only 20% of all persons who need help are using, or have access to, incontinence products.





**SCA's STRATEGY AND MARKET POSITION**

Through organic growth and acquisitions, SCA will strengthen its position as one of Europe's leading manufacturers of hygiene products. Expansion will take place in such markets as Southern Europe, Central and Eastern Europe, as well as in Latin America and Southeast Asia, when favourable opportunities arise for acquisitions and joint ventures. The goal is to increase both sales and cash flow by 12% per year.

Comprehensive and continuous product development, low production costs and the ability to offer the market both SCA brands and private labels are key elements in the Group's strategy. The market for AFH and incontinence products is a priority customer segment. SCA's average share of the market for hygiene products in Europe in 1998 amounted to approximately 20%. SCA has its strongest positions in northern and central areas of Western Europe.

Up to now, SCA's sales in Asia and Latin America have not been affected to any larger extent by the financial uneasiness throughout the world. Export sales to Russia have declined. However, SCA is still in the build-up phase of operations in these regions and sales there amount to 4% of total turnover.

The rationalization of existing mills is continuing and production is being concentrated to certain strategic mills.

A new tissue machine was built during the year in Mannheim and will be completed during the summer of 1999. Kitchen towel rolls and handkerchiefs will be produced with new converting facilities. Production of tissue was also increased in Poland, where a converting

plant was installed.

Production capacity was expanded in the Netherlands to meet rising demand for SCA's pant diaper, a product area in which the company is a clear market leader.

**Acquisitions**

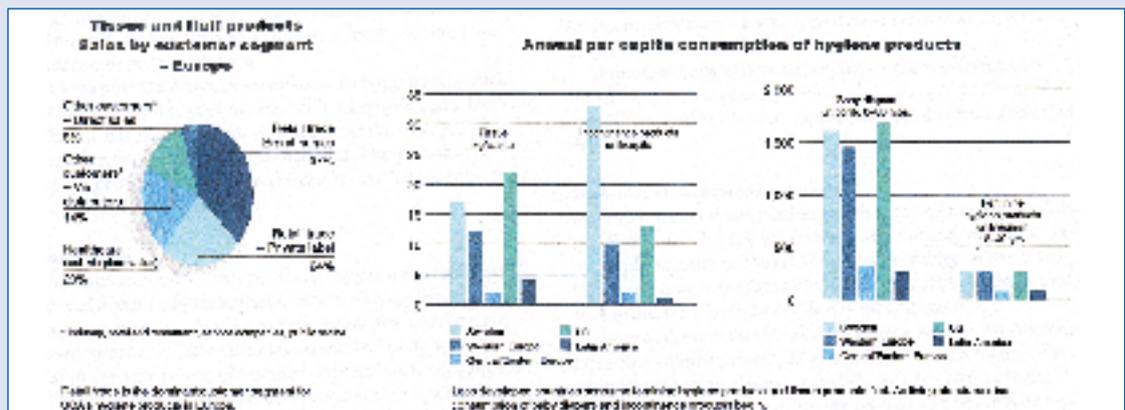
A number of acquisitions were made during the year in line with SCA's growth strategy for hygiene products. The financial uneasiness in the regions where SCA is expanding has created favourable opportunities for acquisitions although there is some uncertainty about profitability in the immediate future. Viewing the situation in a longer perspective, SCA still believes that future growth will be strong.

In Russia, SCA acquired all the shares of Svetogorsk Tissue from Tetra-Laval. Svetogorsk Tissue has the most modern tissue machine in Russia, built in 1989. Its production amounts to approximately 20,000 tons per year, equal to about 20% of the Russian market. The acquisition offers possibilities to produce diapers and feminine hygiene products locally.

In Colombia, SCA increased to 50% its stake in the Productos Familia tissue company, which in turn owns the Tecnopapel tissue company in Ecuador. Negotiations regarding the acquisition of 50% of the Brazilian tissue company Melhoramentos Papeis, which was announced in 1998, are as yet not completed.

SCA has also increased its involvement in Asia with the acquisition of Holland Pacific Paper, a Philippine tissue company. The company currently has the capacity to produce 22,000 tons of tissue per year, plus capacity for 8,000 tons of specialty paper that can be converted to tissue production. The market share in the Philippines amounts to 22%.

In Western Europe, SCA acquired three distributors of incontinence products in France whose total sales amount to SEK 140M. SCA is thereby becoming the market leader in incontinence products in that country.



In the following extract from its 1998 Annual Report and Accounts WPP gives its view of its own and its competitors' likely positions in an industry undergoing structural change.

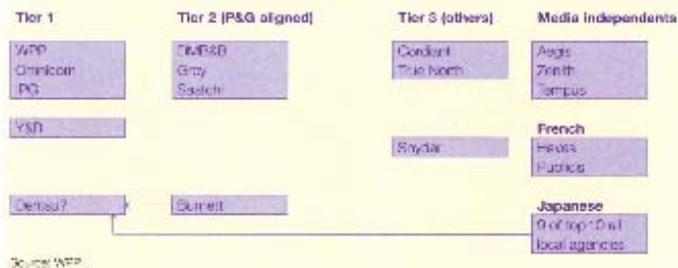
## WPP Group plc

### The oligopoly\* of global advertising agency networks

Agency network	Parent company
<b>The oligopoly</b>	
BBDO Worldwide	Omnicom
DOF Worldwide Worldwide	Omnicom
T&WA International	Omnicom
J. Walter Thompson	WPP
Gilby & Mather Worldwide	WPP
McCann-Erickson	Interpublic
Ammirati Puro Jintas	Interpublic
Young & Rubicam Advertising	Young & Rubicam
DMB&B Communications	MacManus Group
Grey Advertising	Grey Advertising
Leo Burnett Worldwide	Leo Burnett Inc
Saatchi & Saatchi Advertising	Saatchi & Saatchi
<b>The aspirants</b>	
Dentsu	Dentsu
True Worldwide	True North
Bozell Worldwide	True North
Havas H&C	Havas Advertising
Publicis Worldwide	Publicis
Publicis	Publicis
Looney Group	Interpublic

\*Source Goldman Sachs  
 †Limited number of competitors in certain countries

### Advertising, media planning, buying and research: major groupings



### The big five

Recent major consolidation in such industries as oil and automobiles has been and probably will continue to be reflected in the communications services industry. Our industry will probably become increasingly concentrated around five or so groups. Currently these will include Omnicom, IPG, Young & Rubicam, Dentsu and WPP. Dentsu will shortly be following the example of Young & Rubicam's successful public offering and will secure the clout given by a public listing. They have already secured a powerful position by almost developing three 'chains' - their own, their joint venture with Young & Rubicam

DYR and another that would follow from their negotiations to acquire a rumoured stake of between 10% and 40% in Leo Burnett, although the latter deal does seem to be delayed.

Many other groups find themselves in difficult strategic positions. True North, having increased its size significantly through the acquisition of Bozell, still has to develop the latter's international capabilities and prove that their resources can attract and retain multi-national clients. Both Havas and Publicis remain heavily concentrated in France and Europe, the latter having been unable to forge a relationship with True North itself. Procter & Gamble's revision of its conflict policy

will probably make life more difficult for its key agencies as alternatives will open up.

The private Procter agencies such as Leo Burnett and The MacManus Group will become even more acutely aware of their lack of financial resources and will either seek a public listing or merger partner or sale.

It is difficult to see how Burnett's proposed one way partnership with Dentsu will give it sufficient financial fire-power without surrendering control. The public Procter agencies, Grey and Saatchi & Saatchi, have either succession issues to deal with or lack of coverage in functional or geographic areas such as Latin America. All have to raise their games in the media planning and buying areas. Finally, Cordiant, having supposedly split with Saatchi & Saatchi specifically because of the restrictions of the previous Procter conflict policy, needs to strengthen itself geographically and functionally to offer a credible organisation to multi-national clients.

Finally, for the first time, the major Japanese agencies are prepared to consider real equity-based partnerships, such as WPP's alliance with Asatsu-DK, Japan's third largest agency, as they wrestle with servicing the global expansion of Japanese based multi-nationals and worry about de-regulation and increased competition in their own market.

The communications services industry is going through an unprecedented era of structural change.

An example of reporting at the level of a business activity of disclosures linking strategic direction to market attractiveness and competitive position can be derived from the 1998 Annual Report and Accounts of Stakis and relates to its chain of health clubs:

We ask that a company:

- Indicates its strategic direction, together with targets or milestones towards achieving its objectives.

	<p>members to around 100,000. ... Our approach is to continue development of this business partly because the recession impact is unclear but mainly because the unsatisfied demand will continue even in a recession and market growth could</p>	<p>counter the recession effect. Indeed, if the industry does slow down then experience in the USA suggests that a recession would create difficulties for smaller operators and could represent a very good competitive opportunity for us.</p>
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- Explains why management believes it is the right market to be in.

<p>The LivingWell chain of health clubs is relatively new in our portfolio having been acquired in 1996 although we have a long history of operating health clubs within our hotels. We came into</p>	<p>this business because we recognised that there was massive demand and very little supply. Our research in 1996 indicated that there were many towns in the UK which did not</p>	<p>have a health club of our type - large units offering swimming pool, gymnasium, aerobics studio and ancillary features such as hairdresser and beauty treatment.</p>
-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------	------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------	-------------------------------------------------------------------------------------------------------------------------------------------------------------------------

- Describes the business's competitive position within the market.

<p>Since we have moved into the business several competitors have emerged</p>	<p>but we are well placed with the largest circuit by number of outlets and the second</p>	<p>largest by number of members.</p>
-------------------------------------------------------------------------------	--------------------------------------------------------------------------------------------	--------------------------------------

- Predicts, in general terms, the likely future trends anticipated in that market.

<p>The impact of a recession upon this business is unclear since the industry is too new to have experienced one before. There</p>	<p>are two schools of thought: on the one hand health and fitness is discretionary spend and might be an early sacrifice, on the other</p>	<p>hand it is lifestyle expenditure and anecdotal evidence is that customers sacrifice it with great reluctance.</p>
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- States how management intends to maintain or alter the business's position within the market.

<p>The initial strategic thrusts are to standardise operating procedures [in an embryonic industry] and to carry out a programme of new openings ... the operating and control</p>	<p>systems are now standardised. In particular, in October 1998, we moved the membership administration centre ... reducing cost and providing greater security of service. At</p>	<p>the year end the total portfolio was 9 premier clubs and 54 hotel clubs. By the end of 1999 we aim to open a further 7 premier clubs.</p>
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We ask that a company:

- Discloses measures of performance appropriate to the business, including non-financial measures, and/or lead indicators that are used internally to monitor potential in that business.

The following example from the 1998 Annual Report of the Bank of Montreal illustrates comprehensive disclosures relating to its expense-to-revenue ratio, one of the ten key measures monitored by the bank. It also illustrates how shaded boxes can be used to highlight forward looking and predictive statements.



**STRATEGY**  
To achieve sustainable financial growth through the combination of organic and acquired growth, and to ensure robust growth.

**MEASURE**  
Expense-to-revenue ratio, an indicator of our productivity, divided by four measures to compare internal productivity with the productivity of our peers and a capital ratio.

**EXPENSE-TO-REVENUE RATIO (%)**

Year	Ratio (%)
1994	61
1995	64
1996	63
1997	66
1998	68

**NON-INTEREST EXPENSE AND CAPITAL GROWTH**

Year	Non-Interest Expense	Capital Growth
1994	1.1	1.1
1995	1.4	1.2
1996	1.7	1.3
1997	1.9	1.4
1998	2.1	1.5

**STRATEGIC DEVELOPMENT SPENDING**  
Strategic development spending of \$200 million in 1998 was directed to the following initiatives:

- Global – expansion of global activity and
- Relations building – expansion of development and services
- Data – new content of information technology services
- Pathways-Financial Growth Strategy – combination of global and delivery channels

Development spending continues to maintain global spending levels.

**EXPENSE-TO-REVENUE RATIO OF 68.2%**

The expense-to-revenue ratio increased 281 basis points in 1998 to 68.2% as revenue growth of 1.9% was more than offset by expense growth of 4.7%. Our targeted goal to improve productivity by reducing the expense-to-revenue ratio by 2% per annum. The reduction was not achieved in 1998 as a number of the drivers of reduced revenues had a relatively low level of variable expenses which resulted in a deterioration in the expense-to-revenue ratio. These included revenue from impaired loans and equities and funds of local development activities, U.S. card revenue and the lower contribution from Bancamerica. In addition, the decline in trading revenues was not matched by a similar decline in expenses. The drivers for the lower revenue growth are realized on page 26, with expense growth discussed in more detail below.

**Expense Growth at Lower Level in Nineteen**

Our secondary measure of productivity is post-merger expense growth. Expense growth in 1998 was 4.7% compared to 10.8% last year. Contributing to expense growth this year were increased business volume resulting from a strong North American economy; increased spending on strategic development and the foreign exchange impact of a new Canadian dollar. Strategic development spending in the year was directed to the initiatives highlighted on the left of this page. The increase in the Canadian-U.S. dollar exchange rate impacted U.S.-based expenses reported in 1998 resulting in additional expenses of \$69 million. Expense growth was offset by the impact of a \$75 million charge recorded in the fourth quarter of 1997 for accelerated depreciation related to technology systems and costs to improve the efficiency of our credit process, as well as a decline in revenue-driven compensation.

**CONTRIBUTION TO EXPENSE GROWTH (%)**

Contribution Category	1998	1997
Strategic development spending	2.1	4.3
Foreign exchange impact	1.2	0.2
Other	(1.6)	1.3
Increased volume contribution	0.8	5.0
Costs in business volume growth, partially offset by productivity improvements	2.5	0.0
<b>Total expense growth</b>	<b>4.7</b>	<b>10.8</b>

The secondary expense growth in traditional non-interest expense categories (see table below), expense growth was lower in 1998 than 1997 in all categories. Salaries and employee benefits increased 14.6% in 1998, compared to 14.7% in 1997, due largely to reduced variable component in 1998. Professional and equipment expenses increased 4.2%, reflecting additional costs arising from our sales representative structure, including expansion of Learning Communications services launched in 1998, reflecting the continuation of post-merger activities relating to Bancamerica. The increase in other expenses of 11.9% compared to 13.6% in 1997, was largely offset by revenue development spending.

**NON-INTEREST EXPENSE (cents per dollar)**

Category	1998	1997	1996	1995	1994
Salary and employee benefits	1.6	1.7	1.6	1.3	1.5
Professional development	0.2	0.1	0.2	0.2	0.4
Communications	0.8	0.7	0.6	0.5	0.1
Other services	11.3	10.0	4.4	2.2	27.7
<b>Total non-interest expense</b>	<b>4.7</b>	<b>10.8</b>	<b>6.8</b>	<b>4.0</b>	<b>19.7</b>

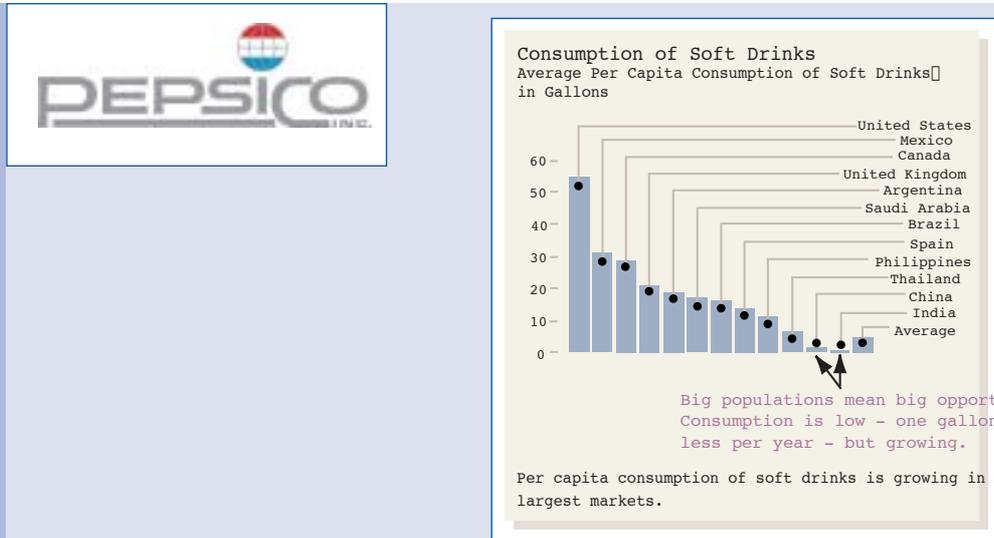
For further details, see table on page 26.

The expense-to-revenue ratio in 1997 was 64.4%, with revenue growth of 15.1% offset by expense growth of 10.8%. Expense growth in 1997 reflected the benefits of productivity improvements which were more than offset by strategic development spending and the \$75 million charge

**NOTES**  
Expense growth in 1998 of 4.7% was less than in 1997 as a result of lower development spending and lower business volume expense growth. Strategic development spending was directed to the initiatives highlighted on the left of this page to achieve productivity improvements.

The examples given earlier in this appendix have included lead indicators such as market growth, market share and the 'hurdle rate' for investment in new projects, which are likely to be important drivers of value for most businesses.

Another example which effectively indicates market potential comes from the PepsiCo website:



Courtesy, PepsiCo, Inc. © 1998.

Some measures are likely to be specific to a particular industry.

Room occupancy is an important performance indicator in the hotel industry, and is illustrated in this example from the 1997/8 Annual Report of Whitbread:



For the pharmaceuticals industry innovation is crucial and SmithKline Beecham indicates in its 1998 Report and Accounts the progress made towards achieving its target for the speed of its product development cycle:



Speed to market is as critical as ever, and our '2,000 in 2000' programme, to reduce the average product development cycle to 2,000 days by the year 2000, remains on target. Progress has been significant in the past five years, and we are now within 10% of achieving our goal.

The publication of performance indicators is an area of reporting developing rapidly in the public sector. The Audit Commission prescribes and publishes a wide range of performance indicators for local authorities and the Health Service. In addition, under the new 'Best Value' regime local authorities will be expected to set their own local measures and indicators and report performance against them. Central government departments and agencies set their performance targets within regimes established by the Government and the reporting of a 5 year trend in performance is mandatory for Executive Agencies and recommended practice elsewhere.

Companies House discloses its performance against target for each of the nine main targets agreed by Ministers and the trend in performance for up to 5 years, together with the targets agreed for the following year. The following extract from its 1998/9 Annual Report shows the performance against target for two of its information processing objectives. These are targets for the speed and the quality of document processing.



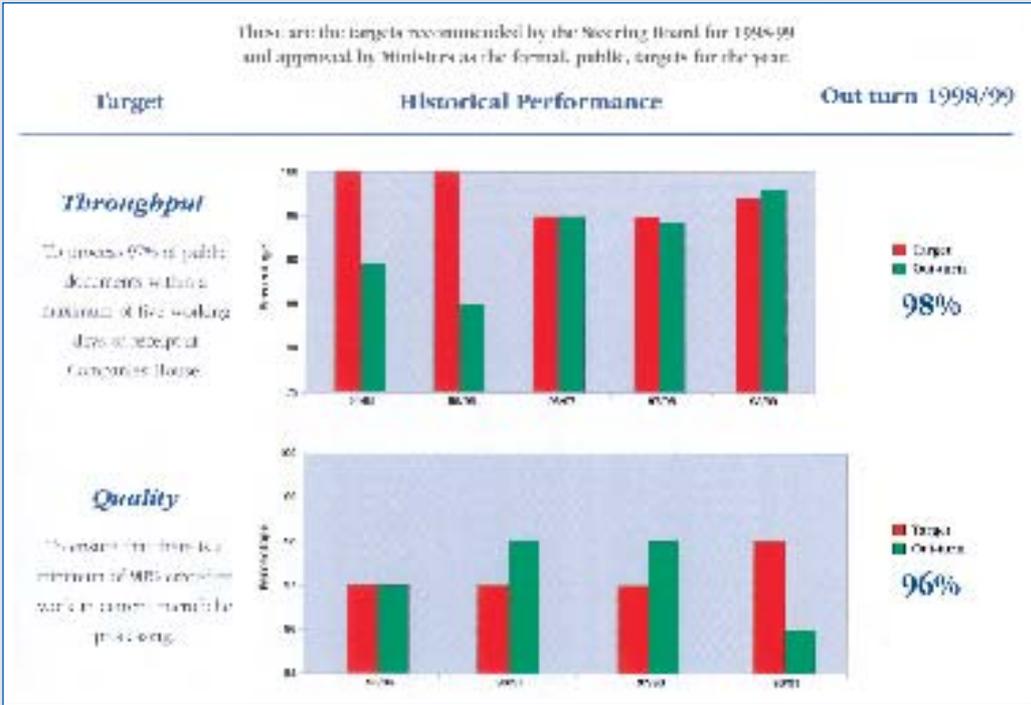
Performance

Throughput

Against a target of making 97% of statutory documents available for inspection within five working days of receipt, we achieved 98% overall. The document processing target has been raised to 99% for 1999-2000 in line with our performance for much of this year. It remains, however, a very stretching, and possibly an over-ambitious target, if we seek to stabilise staff numbers at a time when more and more documents are being presented.

Quality

The fiche quality target for 98% of current fiche to be error-free was missed by 2%, largely due to difficulties in our London office. These were primarily difficulties of timing, rather than quality, which fortuitously came to be measured in the quality target. The target for 1999-2000 remains at 98%.



## Conclusion

Advances in information technology and, in particular, use of the Internet, will undoubtedly affect the future development of the structure of external corporate reporting. 'The Corporate Report-New Horizons' project will, inter alia, consider the impact of new technologies on the form and frequency of corporate reporting. In this paper we have limited ourselves to making proposals for additional disclosures in a company's annual report. We do not believe that this document should be allowed to become of secondary importance to investors and, therefore, believe that it must adopt a more forward looking perspective.

Our proposals reflect this more forward looking perspective and we ask companies to experiment immediately with the additional disclosures we propose. There is nothing radically new in our proposals but putting these disclosures together can present a sharper image and differentiate a company in increasingly demanding capital markets.

The proposals create a link between external reporting and the processes and performance indicators used internally. We believe that this more transparent disclosure will lead to an improved understanding of management objectives and of the risks and opportunities associated with an investment. An improved understanding of the business and management's objectives will permit investors to assess performance against the targets set by management and should, therefore, build management credibility. Better information about the risks and opportunities faced by the company should help investors to value a company more accurately and with less uncertainty, which may reduce capital market volatility.

Whatever the future medium and frequency of external reporting, we believe that reports must better reflect a company's potential for creating value. To do this they must become more forward looking, must take a long term perspective and, through greater transparency, provide a clearer picture of internal operations.

# Appendix I

## The principal shareholder value measures

### The company's perspective

For the company, the implication of the insight 'shareholder value is created by earning a return on capital greater than the cost of capital' is that all decisions, from long term investment decisions to day-to-day operating decisions, should reflect the cost of using equity capital in addition to the cost of debt. This is often referred to as a 'value' focus. Projects which are undertaken should be expected to generate more than the company's cost of capital and measures used subsequently to monitor performance should reflect this cost.

When a 'value' perspective is given to long term, future-oriented decisions, the cost is usually reflected by discounting future cash flows at the company's cost of capital. This is the aspect of shareholder value addressed by Shareholder Value Analysis (SVA) and similar discounted cash flow (DCF) measures.

However companies also want to monitor their short term historical performance. When looking at the results of a single period, a calculation based on accounting profit less a charge to reflect the cost of equity capital is generally considered to be a less volatile indicator of the creation of value than a calculation based on cash flows. This is the justification for use of 'economic profit' measures of shareholder value, including Economic Value Added (EVA).

### The shareholders' perspective

From the shareholders' perspective, the creation of value is reflected in the growth in a company's share price and dividends received. If the stock market prices shares efficiently, the shareholder value created in a period is measured by Total Shareholder Return (TSR). Market Value Added (MVA) similarly measures the total value created by a company since its formation.

The key features of the principal shareholder value measures are listed in Table 1 on the following pages.

**Table 1: The principal shareholder value measures**

Measure:	Basis of calculation:	Principal uses:
Management's valuation of a strategy, business or company e.g. Shareholder Value Analysis (SVA)	<ul style="list-style-type: none"> <li>● Internal i.e. made by management</li> <li>● Future cash flows discounted at a cost of capital (DCF).</li> </ul>	<ul style="list-style-type: none"> <li>● Strategic planning.</li> </ul>
Total Shareholder Return (TSR)	<ul style="list-style-type: none"> <li>● External i.e. stock market based</li> <li>● Dividends plus share price movement as a proportion of the opening share price.</li> </ul>	<ul style="list-style-type: none"> <li>● Performance monitoring at company level</li> <li>● Management remuneration.</li> </ul>
Total Business Return (TBR)	<ul style="list-style-type: none"> <li>● Internal equivalent of TSR</li> <li>● Free cash flow plus change in the valuation of a business as a proportion of its opening valuation.</li> </ul>	<ul style="list-style-type: none"> <li>● Performance monitoring at business level.</li> </ul>
Economic profit measures, including Economic Value Added (EVA)	<ul style="list-style-type: none"> <li>● Internal</li> <li>● Accounting profit less an additional charge for the use of equity capital.</li> </ul>	<ul style="list-style-type: none"> <li>● Performance monitoring at either business or company level.</li> </ul>

	Key features:	Practical challenges and estimations necessary:	Principal assumptions:	Limitations as an externally reported measure:
	<ul style="list-style-type: none"> <li>● Forward looking</li> <li>● Long term</li> <li>● Incorporates management's expectations about the future benefits likely to flow to a business as a result of decisions made or about to be taken.</li> </ul>	<ul style="list-style-type: none"> <li>● The estimation of cash flows in the period explicitly forecasted</li> <li>● The cost of capital.</li> </ul>	<ul style="list-style-type: none"> <li>● The 'fade' assumption for the calculation of the value of residual cash flows.</li> </ul>	<ul style="list-style-type: none"> <li>● Subjectivity.</li> </ul>
	<ul style="list-style-type: none"> <li>● TSR is calculated over a historical period but has a forward looking perspective because it incorporates the stock market's expectations about the future benefits flowing to a company.</li> </ul>	<ul style="list-style-type: none"> <li>● No estimations are necessary in the calculation of TSR itself. However it needs to be compared to the cost of equity capital or to an appropriate peer group.</li> </ul>	<ul style="list-style-type: none"> <li>● Stock market prices accurately reflect all available information.</li> </ul>	<ul style="list-style-type: none"> <li>● It can only be calculated by quoted companies.</li> </ul>
	<ul style="list-style-type: none"> <li>● TBR is calculated over a historical period but has a forward looking perspective if the valuations used are based on a DCF calculation because it then incorporates internal expectations about future benefits flowing to the business.</li> </ul>	<ul style="list-style-type: none"> <li>● The valuation of a business</li> <li>● In common with TSR, TBR needs to be compared to the cost of equity capital or an appropriate peer group.</li> </ul>	<ul style="list-style-type: none"> <li>● The 'fade' assumption for the calculation of the value of residual cash flows, if the business valuations are based on a DCF calculation.</li> </ul>	<ul style="list-style-type: none"> <li>● Subjectivity, if the business valuations are based on a DCF calculation.</li> </ul>
	<ul style="list-style-type: none"> <li>● Historical</li> <li>● Short term, it is usually calculated over one year</li> <li>● These measures reflect the cost of using all capital employed rather than just debt capital</li> <li>● However, they share the limitations of accounting profit in providing information about future potential and economic profitability, particularly where 'revenue investment' is significant.</li> </ul>	<ul style="list-style-type: none"> <li>● Adjustments made to accounting profits so they better reflect economic profitability, e.g. by EVA, add to the complexity of the calculation</li> <li>● The cost of capital.</li> </ul>	<ul style="list-style-type: none"> <li>● That accounting profit is an unbiased indicator of economic profitability.</li> </ul>	<ul style="list-style-type: none"> <li>● Could encourage a short term focus.</li> </ul>

Table 1: The principal shareholder value measures

Measure:	Basis of calculation:	Principal uses:
Cash Flow Return on Investment (CFROI) - usage 1	<ul style="list-style-type: none"> <li>● Internal</li> <li>● Free cash flow as a proportion of capital invested.</li> </ul>	<ul style="list-style-type: none"> <li>● Performance monitoring at either business or company level.</li> </ul>
CFROI - usage 2	<ul style="list-style-type: none"> <li>● Internal</li> <li>● Current level of free cash flow is assumed to continue over the remaining life of the asset base and CFROI calculated as the IRR equating this to the current value of the asset base.</li> </ul>	<ul style="list-style-type: none"> <li>● Strategic planning.</li> </ul>
Market Value Added (MVA)	<ul style="list-style-type: none"> <li>● Hybrid, incorporating both stock market and accounting values.</li> <li>● Market capitalisation less total capital invested, including retained earnings.</li> </ul>	<ul style="list-style-type: none"> <li>● Performance over the whole period since incorporation of a company.</li> </ul>

	Key features:	Practical challenges and estimations necessary:	Principal assumptions:	Limitations as an externally reported measure:
	<ul style="list-style-type: none"> <li>● Historical</li> <li>● Short term, it is usually calculated over one year</li> <li>● A return on investment calculation reflecting a focus on cash rather than profit.</li> </ul>	<ul style="list-style-type: none"> <li>● Current value, rather than book values, may be used for capital invested</li> <li>● CFROI needs to be compared to the cost of capital.</li> </ul>	<ul style="list-style-type: none"> <li>● That cash flow is a reliable indicator of performance as it is subject to more volatility than profit.</li> </ul>	<ul style="list-style-type: none"> <li>● Could encourage a short term focus.</li> </ul>
	<ul style="list-style-type: none"> <li>● Forward looking but simplistic assumptions made</li> <li>● An indicator of whether it is appropriate to replace the asset base.</li> </ul>	<ul style="list-style-type: none"> <li>● Current values, rather than book values, are used for the asset base</li> <li>● Calculation of the average life of the asset base</li> <li>● CFROI needs to be compared to the cost of capital.</li> </ul>	<ul style="list-style-type: none"> <li>● Future cash flows remain at the current level for the life of the existing asset base</li> <li>● Cash flows during the remaining life of the asset base can be reinvested at the CFROI.</li> </ul>	<ul style="list-style-type: none"> <li>● Subjectivity.</li> </ul>
	<ul style="list-style-type: none"> <li>● MVA is calculated over the life of a company but has a forward looking dimension, being based on market capitalisation</li> <li>● If the total capital invested is based on book values the calculation is distorted, e.g. by intangibles such as research and development, which are written off for accounting purposes but which do have an economic value.</li> </ul>	<ul style="list-style-type: none"> <li>● Adjustments made to accounting values so they better reflect economic values add to the complexity of the calculation.</li> </ul>	<ul style="list-style-type: none"> <li>● Stock market prices accurately reflect all available information.</li> </ul>	<ul style="list-style-type: none"> <li>● Comparisons between companies are of limited use as different periods of time and different company sizes are being compared.</li> </ul>

## Appendix II

### Evidence of investors' information needs

Recent surveys of investors' demand for and use of information confirm their desire for more forward looking information in a company's annual report and the importance of drivers of future performance to their investment decisions. These surveys are summarised in the table below.

**Table 2: Surveys of investors' demand for and use of information**

Conducted by and reported in:	Areas covered:	User group(s):	Focus of survey/report:	No.	Inter-views	Survey
ICAS Business Reporting: The Inevitable Change? 1999	UK	Institutional and private investors, analysts and bankers.	Investors' and lenders information needs, including a postal survey of performance drivers.	93	13	80
DTI Creating Quality Dialogue, 1999	UK	Institutional investors.	Institutional investors' need for forward looking information.	13	13	
Shelley Taylor & Associates Full Disclosure 1998	UK, US and Switzerland	Institutional investors.	Investors' optimal disclosure.	25	25	
Ernst & Young Measures that Matter, 1998	US	Portfolio managers.	Use of non-financial factors in the investment decision.	275		275
PwC e.g. Pursuing Value: Reporting Gaps in the United Kingdom, 1997	UK, US and 12 other countries	Financial analysts and institutional investors.	Importance of 21 specific measures and the adequacy of their reporting.	Approx 700		Approx 700

#### The demand for forward looking information

The reports of the interviews conducted by the Institute of Chartered Accountants in Scotland (ICAS), the Department of Trade and Industry (DTI) and Shelley Taylor & Associates<sup>21</sup> all confirm an increasing demand for future-oriented information by investors. ICAS quotes the following as comments typically made by users of the annual report:

*"Investors demand for increased information is growing strongly.*

*I would prefer to see far more information of a prospective nature.*

*Additional information on expectations of future performance would be useful."*<sup>22</sup>

<sup>21</sup> Reported in *Full Disclosure 1998*, Shelley Taylor & Associates.

<sup>22</sup> *Business Reporting: The Inevitable Change?* ICAS, March 1999, p.53.

In addition, the DTI notes in its report:

*“Fund managers we interviewed ... criticise a concentration [by smaller quoted companies or SQC’s] on the past and a reluctance to volunteer the information they need to reach an informed view about the company and its prospects. ...[They] want SQC’s to publish more forward looking information.”<sup>23</sup>*

### **Drivers of future performance**

The surveys by ICAS, Shelley Taylor & Associates and the Ernst & Young Centre for Business Innovation<sup>24</sup> consider, in different ways, indicators of future prospects. A consistent conclusion is the pivotal role of management, its strategy and the challenges and risks that must be managed to execute that strategy successfully.

As part of its investigation of users’ needs, ICAS conducted a postal survey of drivers of company performance. It was found that the most important generic drivers of performance were considered to be:

- Quality of management;
- Company strategy;
- Industry within which the company operates.

And, of the 29 factors surveyed, the most important specific factors were:

- Integrity of management;
- Vulnerability of company to competition;
- Ability of management to achieve targets;
- Acquisition strategy (past performance and future plans);
- Recent changes in quality of management, corporate succession and management style;
- Experience of management;
- Corporate strategy for the development of existing operations.

Institutional investors interviewed for the report “Full Disclosure 1998” confirmed this focus on the ‘quality of management’. To help them form a view on this, they wanted enhanced disclosures relating to accountability, more industry, market and segmental data and more future-oriented information, as summarised in Table 3 below.

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<sup>23</sup>Creating Quality Dialogue between Smaller Quoted Companies & Fund Managers, DTI, February 1999, pp.9 and 11

<sup>24</sup>Reported in *Measures that Matter*, Ernst & Young LLP, 1998.

**Table 3: Highlights from “Full Disclosure 1998”<sup>25</sup>**

Accountability	Industry and Market	The Future	Segmental
Objectives Objectives vs. Results Strategy Values / Management Philosophy Mission/Purpose Challenges/Risks Bad News	Industry Competitors Brands	Forward Looking Statements Strategy Challenges / Risks	Capital Expenditure R&D Activities R&D Spending Holdings Segmental – Business Segmental – Geography

Researchers from the Ernst & Young Centre for Business Innovation took their analysis a step further. They obtained evidence not only about the non-financial factors portfolio managers said were useful to them but also, through a simulation of the share purchase decision, they collected evidence of the actual use of such non-financial data. In the simulation they altered the non-financial information presented to portfolio managers about a company but held constant the financial information presented. They found that the decision whether to purchase that company’s share was affected by the changing non-financial information.

Again the focus on the quality of management and its strategy was apparent, with the information of the greatest value to portfolio managers being information relating to:

- **Strategy execution;**  
*“how well management leverages its skills and experience, gains employee commitment and stays aligned with shareholder interests.”<sup>26</sup>*
- **Management credibility;**  
*which will, primarily, depend on two of the factors found to be very important to investors in the ICAS study; the integrity of management and its ability to achieve targets.*
- **Quality of strategy;**  
*“management’s vision for the future, whether it can make tough decisions and quickly seize opportunities, and how well it allocates resources.”<sup>27</sup>*

However, the importance of particular non-financial factors varied across industry groups, with information about the strength of a company’s market position most valuable in the oil and gas industry and information about the effectiveness of new product development most important in the pharmaceuticals industry.

PricewaterhouseCoopers has commissioned telephone surveys of financial analysts and institutional investors in 14 countries over the past four years.<sup>28</sup> This work focused on the importance to financial

<sup>25</sup>As shown at the ICAEW Breakfast Briefing on *Full Disclosure 1998* by Shelley Taylor.

<sup>26</sup>*Measures that Matter*, Ernst & Young LLP, 1998 p.1

<sup>27</sup>*Measures that Matter*, Ernst & Young LLP, 1998 p.2.

<sup>28</sup>The UK survey is reported in *Pursuing Value: Reporting Gaps in the United Kingdom*, I Coleman & R Eccles; Price Waterhouse 1997

analysts and institutional investors of 21 specific measures of performance, both financial and non-financial, and the adequacy with which they are currently reported. The work confirmed the importance of traditional financial measures but also highlighted the desire for market share and market growth information, investment in research and development, capital expenditure and statements of strategic goals. Those who wanted this information were dissatisfied with the adequacy of its current reporting.

Other non-financial performance indicators were, overall, viewed as being less important. Table 4 indicates the percentage of the analysts and investors surveyed who found a particular measure valuable in the UK survey.

**Table 4: Usefulness of specific performance measures to analysts and investors**

Performance measure:	UK data	
	Analysts	Investors
	%	%
Cost data	94	31
Segment performance data	88	22
Earnings data	85	87
Cash flow data	85	83
Market growth data	85	71
Market share data	82	75
Capital expenditure	78	52
R&D investment	73	29
Statements of strategic goals	72	52
Employee productivity	70	16
New product development	66	34
Customer retention	51	9
Product quality	50	7
R&D productivity	48	19
Intellectual property	39	13

The other performance measures surveyed, which were considered valuable by less than a third of either group overall, were: process quality data; employee training levels and expenditures; customer satisfaction measures; employee turnover rates; environmental compliance data and employee satisfaction measures.

The PwC survey did not indicate a strong demand from investors for the majority of the non-financial measures. We believe that there are two reasons for this survey undervaluing the potential usefulness of these measures. Firstly, investors prefer ‘hard’ measures such as cash flow data to ‘softer’ measures such as satisfaction ratings because ‘hard’ data is thought more difficult to manipulate. However, in a follow-up survey of the use by management of the same measures, customer satisfaction was said to be important by 66% of senior executives and employee satisfaction by 44%<sup>29</sup>.

Secondly, we believe that the important value drivers and, therefore, indicators of performance derived from them, vary from industry to industry and business to business. This belief is supported by evidence from the Ernst & Young survey described earlier that the relative importance of specific non-financial factors varied across industry groups. We therefore propose only disclosure of those indicators that relate to the key ‘value drivers’ for a particular business and are, therefore, central to the successful implementation of strategy.

<sup>29</sup>Reporting Gaps in the UK: The Chief Executive's Perspective; R. Eccles, D. Phillips, H. Richards, PricewaterhouseCoopers, 1998.

## Appendix III

# Examples of performance indicators

### *Summary indicators:*

#### Non-financial

- Market share
- Market growth
- Customer retention
- Customer satisfaction
- Price premium

#### Financial

- Revenue growth
- Economic profit
- Return on capital
- Market/customer profitability

### *Indicators relating to specific drivers of value:*

#### Process quality

- Reject rate
- Scrap
- Warranties/returns

#### Timeliness

- On time delivery
- Customer response time
- Cycle time

#### Productivity

- Employee productivity
- Asset utilisation

#### Flexibility

- Changeover time

#### Marketing

- Customer acquisition

#### Information Technology

- IT investment

#### Innovation

- New product development
  - % of sales from new products
  - Product pipeline
- R&D investment
- R&D productivity

#### Human Resources

- Competence
  - Training (hrs/spend)
- Morale
  - Employee turnover
  - Employee satisfaction
  - Application rates

#### Environmental

- Compliance with legislation

## Appendix IV

# Members of the Steering Group

The members of the Steering Group are:

### *Ken Lever, Chairman*

Ken Lever has recently been appointed Finance Director of Tomkins PLC and is a non-executive director of VEGA Group PLC and Merewood Group Limited. He is a Chartered Accountant and a member of the ICAEW Financial Reporting Committee. He has held executive directorships at Albright & Wilson plc, Alfred McAlpine plc and Corton Beach plc and was a partner in Arthur Andersen.

### *Guy Ashton*

Guy Ashton is responsible for equity analysis and valuation methodology at HSBC Securities. He is a Chartered Accountant and prior to joining HSBC was a consultant on equity valuation for brokers, fund managers and corporates.

### *Lesley Davey*

Lesley Davey is Group Finance Director of The African Lakes Corporation PLC. She is a Chartered Accountant and a member of the ICAEW Financial Reporting Committee. She has previously been Finance Director at Ladbroke Casinos Limited, Borthwicks plc and Rage Software plc.

### *Chris Higson*

Chris Higson is Professor of Accounting at London Business School. He has taught financial analysis and valuation on all of the School's major programmes and researches in company valuation and mergers and acquisitions. He is a Chartered Accountant and has advised many leading financial institutions and industrial companies.

### *Robert Langford*

Robert Langford is the ICAEW's Head of Financial Reporting. He is a Chartered Accountant and has previously held positions at Lloyds Bank Plc and the IASC. He is also responsible for supporting the Institute's work on environmental reporting and auditing.

### *Kathy Leach*

Kathy Leach is the Project Manager supporting this project for the ICAEW. She is a Chartered Accountant and previously lectured at Warwick Business School. Prior to that she worked in financial reporting and corporate taxation in the motor industry.

### ***Cameron Maxwell***

Cameron Maxwell is a non-executive director of Avesco Plc and was formerly its Finance Director. He is a director of a number of private companies. Cameron is a Chartered Accountant and both a member of the Council of the ICAEW and its Technical Advisory Committee.

### ***David Munns***

David Munns is Corporate Controller at the Financial Times Group, moving recently within Pearson plc from a group role as Head of Financial Planning & Analysis. He is a Chartered Accountant and holds an MBA from the University of Chicago, noted for its shareholder value program.

### ***David Phillips***

David Phillips is a partner in PricewaterhouseCoopers' Assurance /Business Advisory Services and leads its European ValueReporting™ initiative. He is a Chartered Accountant and co-author of a paper analysing the use of and external communication of a range of performance measures by UK executives.

### ***Ian Roundell***

Ian Roundell is Head of Investor Relations at Barclays PLC and prior to that worked in both financial and regulatory reporting within the group. He is a Chartered Accountant and previously worked in corporate finance and management consultancy at Deloitte and Touche.

### ***David Thompson***

David Thompson is Joint Group Managing Director and Group Finance Director of The Boots Company PLC, where he is responsible for Boots Healthcare International and Halfords Limited as well as all finance related matters. He is a Chartered Accountant, a member of The Hundred Group of Finance Directors and a non-executive director of Cadbury Schweppes PLC.

### ***Steve Webster***

Steve Webster is Group Finance Director of Wolseley plc. He is a Chartered Accountant and Chairman of the Midlands Industry Group of Finance Directors. Steve was previously a partner in Price Waterhouse.

### ***Mike Weston***

Mike Weston is a director of the UK Institutional Division of Merrill Lynch Mercury Asset Management where he has responsibility for co-ordinating research into the global consumer goods sector. Mike is a member of the IIMR and was formerly a director of Hermes Investment Management.



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