

WHITE PAPER

Optimal Transparency

Shouldn't Investors Know
What the Board Knows?

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LEGISLATIVE, REGULATORY AND MARKET FORCES ARE CREATING inexorable pressures for companies to become more transparent in the performance information that they provide to the market. Company executives should respond to this trend by defining and implementing the optimal level of transparency beyond what is required by law and regulation. It is in their self-interest to do so.

The starting point here is a simple one: Assume that whatever information

is useful for top management and the board will be useful to investors as well—and they should have it.

SETTING INFORMATION BOUNDARIES

Senior investor relations officers have a simple choice. They can encourage the CEO, CFO and board of directors to practice an optimal level of transparency—or not.

Optimal level of transparency means the fullest disclosure possible on company performance so that investors and other stakeholders have the information that they need to make decisions. In its simplest terms, optimal transparency means providing the information that the investor relations officer would want as an outside investor in a company. Clearly he or she would not want information that would enable competitors to hurt the company's ability to create value for its shareholders. Although this concern is legitimate, it frequently is exaggerated. Competitors often already have information that management regards as proprietary, just as management typically has such information about other companies.

By choosing not to be an advocate of optimal transparency, the investor relations officer has made the decision to implement the disclosures that management and the board deem appropriate. That level of transparency can be very high, or it can be something more modest. Although regulations like those contained in the Sarbanes-Oxley Act and subsequent Securities and Exchange Commission rulings have increased disclosure requirements, they still fall almost entirely within the existing financial reporting model.

Today's investors certainly want accurate and timely financial information based on GAAP, but they also want a wide range of other information to give them a complete view of a company's performance and prospects. That additional information is often about intangible assets and nonfinancial value drivers that are the leading indicators of future financial results.

Optimal transparency means making that kind of information available, even though there are few regulatory pressures on U.S. companies to do so. Optimal transparency is about being accountable to shareholders rather than merely complying with a checklist of rules.

Executives, analysts and investors alike should be concerned when the market is overly focused on short-term earnings and fails to understand and reward decisions that will create real value over the long term. A focus on short-term earnings with seemingly predictable increases quarter by quarter is especially tempting when the market is going up. But myopic focus on this indicator at the exclusion of many others was a key culprit behind recent bad corporate behavior, including spawning form over substance in accounting.

In reality, earnings performance is rarely smooth quarter to quarter. The fact that it isn't has little to do with building long-term, sustainable value. The sooner market participants own up to this, the easier it will be to consider other measures and achieve optimal transparency. While bottom-line performance clearly is important, so are the leading indicators that produce the bottom-line results, in both bull and bear markets.

THE BENEFITS OF OPTIMAL TRANSPARENCY

Over the past five years, PricewaterhouseCoopers has conducted surveys of 557 executives, 488 sell-side analysts and 580 institutional investors in 14 industries. These surveys have shown that all groups see real benefit in greater disclosure. The most important ones cited are:

- Increased management credibility
- Higher share values
- More long-term investors
- Improved access to new capital
- Increased analyst following
- A better-managed company

Not only are these benefits self-explanatory but also they are especially important in today's business climate, in which public trust in corporations still has not returned. However, it's worth singling out the first and last benefits for further discussion.

Increased management credibility is the foundation for the market to believe a company's promises about what it is going to do in the future. Since share prices are based on expectations about the future, if management lacks credibility in both the accuracy of reported results and what it says it is going to accomplish, share prices will suffer.

When optimal transparency is practiced, shares should trade close to real value. When credibility is severely strained, shares are consistently undervalued as risk increases. This is not a position in which a company wants to find itself.

Alternatively, everything can seem fine and shares may actually trade above real value. Until recently that might have been considered an advantageous position. But eventually management's credibility will be challenged when it becomes obvious that past disclosures were inaccurate or incomplete. When this happens, share prices decline suddenly and dramatically—an uncomfortable time for the investor relations officer.

In terms of the last benefit on the list, higher levels of transparency result in a better-managed company for the same reason that greater internal transparency leads to better performance. When all levels of management have accurate, complete and timely information, they are better able to effectively monitor the actions and performance of those who report to them. This is simply good management discipline.

When boards of directors and shareholders have that kind of information, the discipline extends to the capital markets and improves performance as well. If the CEO and CFO believe that transparency should stop with them, they are denying themselves the benefit of the same kind of constructive

and disciplined feedback that they are providing to executives in their own organizations.

ESTABLISHING THE OPTIMAL LEVEL OF TRANSPARENCY

Assuming that the investor relations officer has persuaded the CEO, CFO and the board that optimal transparency is the right thing to do, how can it be implemented?

There are only four steps, but each requires careful analysis.

1. Identify key value drivers and metrics
2. Construct the business model(s)
3. Conduct the cost/benefit analysis
4. Review with the board of directors

Most companies have a good idea of the key financial and nonfinancial value drivers of their business. Terms such as *balanced score card* and *key performance indicators* have become common business parlance. In Step 1, management identifies the value drivers for each distinct business unit. The figures show value drivers for 14 industries, although the list will vary by company and by strategy.

The bigger challenge is to identify reliable ways to measure the value drivers. Although financial metrics are universal, nonfinancial metrics are still being developed.

Step 2 is more difficult because it involves specifying each major unit's business model—the translation of strategy into value drivers and their metrics. The business model represents the cause-and-effect relationships among the key value drivers and shows leading and lagging indicators with respect to each other.

The business model is usually implicit in executives' minds. However, too often individual executives have their own models, and they aren't aware of differences until they are forced to be explicit about them. Making them do so and reaching a consensus on the business model leads to a better-managed company.

Step 3 requires the most discipline because it involves carefully analyzing the costs and benefits of greater transparency. Here in point-counterpoint form are some of the key issues that must be addressed:

- Our competitors will use this against us—
Investors reward companies for greater transparency.
- The market only cares about earnings—
The capital markets are evolving rapidly.
- Once we start providing this information we can't stop—
As long as information is relevant the market will want to know it.
- Our stock price will suffer if the number goes down—
The stock price will increase when the number goes up.
- Gathering and providing this information is expensive—
Information-gathering is the most expensive part now that the Internet makes distribution much less costly. If the information is useful, management should have it.
- The more information we provide, the more likely it is that we'll be sued—
Greater transparency over time will decrease the likelihood of lawsuits.

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There are no easy answers here. Senior management, guided by the investor relations officer, must carefully consider both the upside and

downside of greater transparency. Too often, the upside benefits of greater transparency—especially the trust it would build in the equity markets—have not been considered in a meaningful way. For any given company the definition of optimal transparency will be based on industry structure and dynamics, the company’s strategy, and the seasoned judgments of management and the board.

This leads to Step 4, the one taken by some of today’s most sophisticated companies. Key value drivers, business models and the cost-benefit analysis of what to report externally should be reviewed with the board of directors. Often the board also will find that analysis to be an educational and useful exercise because it will not have been privy to the information before. And since the board has a fiduciary duty to represent shareholders, it is responsible for making sure that the company is reporting the information that will lead to the most accurate stock price.

The senior investor relations officer typically does not have access to the board, but this must change if optimal transparency is the goal.

It is the role of the board, not management, to set the company’s objectives for corporate reporting to investors and to make the final determination of whether the benefits of greater transparency to shareholders exceed the costs. Ultimately, therefore, it is the responsibility of the board of directors to determine the optimal level of transparency. ■

IMPORTANT COMPANY VALUE DRIVERS BY INDUSTRY

BANKING	CHEMICALS	CONSUMER GOODS
<ul style="list-style-type: none"> Loan Loss Earnings Capital Adequacy Risk Management Practices Customer Retention Customer Penetration Asset/Liability Management Asset Quality Return on Risk-Adjusted Capital Capital Management Quality of Management Plans for Growth Market Growth Fee-Based Revenue Growth Delivery Channels Economic Profit Performance by Business Segment Market Risk Exposure Cost/Income Market Share Assets Under Management Employee Satisfaction Brand Equity Product Innovation Investment Performance Degree of Diversification Regulatory Reputation IT Expenditures 	<ul style="list-style-type: none"> Free Cash Flow Strategic Direction Manufacturing Costs Earnings Market Growth Performance by Business Segment Product Quality Quality of Management Capital Expenditure Utilization of Facilities Market Share Customer Loyalty 	<ul style="list-style-type: none"> Capital Expenditure Free Cash Flow Sales Volume Quality of Strategy Growth Strategy Performance by Business Segment Market Growth Performance by Geographic Market Marketing Strategy Customer Loyalty and Advocacy Customer Service Weighted Average Cost of Capital Employee Satisfaction and Advocacy Earnings Sales and Gross Margins by Product Category Market Share Product Innovation Marketing Costs Brand Portfolio Management Data Percent of New Products in Sales Employment, Environmental Policies Product Range Development Stock Levels in the Supply Chain Distribution Channel Complexity

IMPORTANT COMPANY VALUE DRIVERS BY INDUSTRY

DIVERSIFIED MANUFACTURING

Free Cash Flow
 Performance by Business Segment
 Market Growth
 Earnings
 Manufacturing Costs
 Quality of Management
 Strategic Direction
 Capital Expenditures
 Market Share
 Product Quality

HIGH TECHNOLOGY

Strategic Direction
 Cash Flow
 Market Growth
 Gross Margins
 Quality/Experience of Management Team
 Market Size
 Competitive Landscape
 Earnings
 Speed to Market (first to market)
 Market Share

INSURANCE

Performance by Business Segment
 Expense Ratio
 Capital Management
 Risk Management Practices
 Plans for Growth
 Investment Performance
 Distribution Channels
 Quality of Management
 Earnings
 Asset/Liability Management
 Return on Risk-Adjusted Capital
 Market Growth
 Customer Retention
 Capital Adequacy
 Claims Ratio
 Economic Profit
 Employee Satisfaction
 Customer Penetration
 Market Risk Exposure
 Assets Under Management
 Asset Quality
 Embedded Value
 IT Expenditures
 Brand Equity
 Product Innovation
 Regulatory Reputation
 Market Share

INVESTMENT MANAGEMENT

Profit Margins
 Investment Product Performance
 Quality of Management
 Asset Growth From Investment Performance
 Asset Growth From Product Cash Flow
 Employee Retention
 Compensation Levels of Professional Staff
 Asset Retention
 Competitive Landscape
 Product Diversification Strategy
 Compensation Strategy
 Investment in Technology to Improve Business Processes
 Assets Under Management
 Enterprise Risk Management
 Market Share
 Experience/Quality of Investment Research Professionals

IMPORTANT COMPANY VALUE DRIVERS BY INDUSTRY

METALS	MINING	PETROLEUM
<ul style="list-style-type: none"> Market Share Energy Prices and Supply Earnings Costs per Ton Delivered Market Growth Metals Prices Capital Expenditures Performance by Business Segment Potential Supply Globally and Locally Utilization of Facilities Product Quality Free Cash Flow Age and Quality of Plant Strategic Direction Value of Tangible Assets Implementation of New Processes and Technologies Quality of Management Regulatory Environment 	<ul style="list-style-type: none"> Strategic Direction Cash Cost per Ounce/Kg/Ton Capital Expenditures Earnings Existing/Potential Environmental Liabilities Health and Safety Performance Statistics Metal Prices Quality of Management Acquisition Strategies Ounces/Kilograms/Tons Produced per Year Performance by Business Segment Cost per Ounce/Kg/Ton Labor Relations Sustainable Development Strategy Environmental Policy/Risks Potential Supply/Production Globally and Locally 	<ul style="list-style-type: none"> Supply, Demand and Prices for Petroleum Products by Region Cash Flow Unit Cost by Refinery Value of Proven and Probable Reserves Refinery Margins by Region Capital Expenditures Strategic Direction Reserve Replacement Costs Refinery Utilization Refinery Acquisition Cost of Crude Earnings Supply, Demand and Prices for Crude Oil and Natural Gas Performance by Business Segment Exploration Success Rate Return on Average Capital Employed or Similar Return Measure Quality of Management Petroleum Product Sales by Volume by Refinery Risk Management Quality of Work Force Hedging Strategy Market Share Operating Profit per Equivalent Measure by Geographic Location

IMPORTANT COMPANY VALUE DRIVERS BY INDUSTRY

PHARMACEUTICALS	REAL ESTATE	TELECOMMUNICATIONS
<p>Market Growth and Potential by Therapeutic Area</p> <p>Product Focus Strategy</p> <p>Earnings</p> <p>R&D Pipeline</p> <p>Market Share by Therapeutic Area</p> <p>Regulatory Issues</p> <p>Product Innovation Strategy</p> <p>Performance by Business Segment</p> <p>Effectiveness of Product Launch</p> <p>Reputation With Prescribers</p> <p>Quality of Management</p> <p>Market Growth and Potential by Geographic Area</p> <p>Market Growth by Geographic Market</p> <p>Partnering Strategy</p> <p>Cost/Revenue Ratios</p> <p>Quality of Selection of Development Targets</p> <p>Recruitment and Retention of Talented People</p> <p>Risk Profile of Product</p> <p>Efficiency of Manufacturing Facilities</p> <p>Profitability of Licensing Arrangements</p> <p>Economic Profit</p> <p>Value of Key Intellectual Assets</p> <p>Brand Awareness Levels With Patients</p>	<p>Financing Strategy</p> <p>Occupancy Rate</p> <p>Macro-Economic Factors (e.g., GDP growth, inflation, population and job growth, interest rates)</p> <p>Investment Strategy</p> <p>Return on Invested Capital</p> <p>Revenue From New Developments or Acquisitions</p> <p>Investment in New Acquisitions and Development Properties</p> <p>Earnings</p> <p>Market Rental Rate</p> <p>Quality of Management</p> <p>Free Cash Flow</p> <p>RETAIL</p> <p>Market Growth</p> <p>Earnings</p> <p>Same-Store Sales</p> <p>Gross Margins</p> <p>Free Cash Flow</p> <p>Market Share</p> <p>Performance by Business Segment</p> <p>Store Portfolio Changes (e.g., new stores)</p> <p>Weighted Average Cost of Capital</p> <p>Customer Satisfaction</p> <p>Expected Return on New Stores</p> <p>Refurbishment</p> <p>Quality of Management</p> <p>Capital Expenditures</p> <p>Sales per Square Foot</p> <p>Inventory Turns</p> <p>New Store Formats Tested and Performance Data</p> <p>Brand Value</p> <p>Product Availability</p>	<p>Competitive Landscape</p> <p>Capital Expenditures</p> <p>Market Growth</p> <p>Customer Churn Rate</p> <p>Regulatory Environment</p> <p>Pricing Strategy</p> <p>Network Reach, Quality and Capability</p> <p>Earnings</p> <p>Revenue Metrics by Driver (e.g., average revenue per user)</p> <p>Significant Operating Costs by Category</p> <p>Sales and Marketing Strategy</p> <p>Cash Flow by Business Segment</p>