Thinking

invisible ink

Regulation requiring companies to report on intangible assets is coming soon to the UK and other countries. Yet, argues **Kim Warren,** unless investors understand how such 'soft' factors actually work through the business system to drive performance, they stand little chance of estimating the strength of its strategy, or understanding firms' likely performance prospects and value.

→ There has been considerable interest in recent years in the role that intangible factors, such as reputation, staff skills, and business relationships, play in the strategy and performance of commercial organisations. Executives fully understand the importance of sustaining these vital factors, and academics have devoted much effort to understanding how they operate.

Lately, though, investors have also taken an increasing interest in intangibles, and regulators in both Europe and the US have also turned their attention to the issue. Underlying this interest is a concern that management, in an effort to deliver shareholder expectations, may inadvertently damage commercial fundamentals on which future prospects of the business rely.

The EU has published guidelines on the subject. And, in the UK, regulation is seemingly imminent after a consultation period.Us reporting requirments are heading in a similar direction.

The consultation document on the *Operating and Financial Review and Directors' Report* (OFR), published by the UK's Department of Trade and Industry, observes: "Company accounting and reporting remains essentially backward looking and based on financial indicators. There are few statutory requirements to report on the main qualitative factors which underlie past and future performance (or for future performance, even financial factors) – in particular on strategy, prospects, opportunities and risks; on intangible, and so-called 'soft', assets (which may contribute significantly to success but are not well captured in traditional financial statements); and on key business and wider relationships. As a result, the information provided is defective and directors do not have the discipline of accounting for stewardship on some key responsibilities."

Moves to regulate the reporting of intangibles raise a fundamental question – would investors know what to make of information about intangible factors if it *were* provided? Managers with considerable experience of actually running a business find it hard enough to understand how intangibles impact on future performance. It is difficult to see how outsiders will be able to make sense of them. It is perhaps not surprising, then, that responses to the draft UK regulations suggest that boards and their advisors are uncertain as to how exactly to comply with the requirements.

Intangible shopping

Consider the history of investor expectations and performance of the iconic British retailer Marks & Spencer (M&S). Few businesses are as open about intangible factors affecting their performance, or as studied by analysts and commentators. Yet the recent years have been a roller-coaster of overblown expectations, major disappointments, hoped-for recovery, and agonising progress.

Surely, if management and investors shared a good understanding of how M&S performance depended on well-known intangibles, little of this confusion and angst should have occurred?

In 1998 profits were £1.1 billion, with analysts expecting more of the same in 1999, in spite of well-known information that the company's reputation for quality, service, and value had been in steady decline since the early 1990s. Recovery was expected in both 2000 and 2001, even though the spotlight was firmly fixed on these continuing poor intangibles. So why were investors surprised when this recovery failed to materialise? More recent years have seen desperate efforts by M&S to keep delivering profitability, while at the same time

Extract from the DTI's draft regulations on the operating and financial review and directors' report

(schedule 7ZA, pp. 44-45) – emphasis added.

An operating and financial review shall be a balanced and comprehensive analysis of –

(a) the development and performance of the business of the company and its subsidiary undertakings during the financial year.

(b) the position of the company... at the end of the year.

(c) the main trends and factors underlying the developing, performance and position of he business... during the financial year, and

(d) the **main trends and factors which are likely to affect their future development, performance and position, prepared so as to enable the members of the company to assess the strategies adopted by the company... and the potential for those strategies to succeed.**

The review shall include –

(a) a statement of the business, objectives and strategies of the company and its subsidiary undertakings;

(b) a **description of the resources available to the company...**

(c) a description of the principal risks and uncertainties; and

(d) a description of the capital structure, treasury policies and objectives and liquidity of the company and its subsidiary undertakings.

Thinking

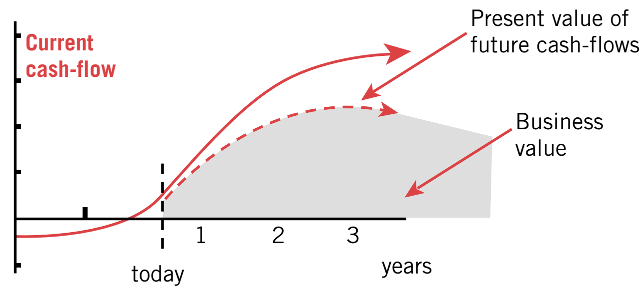

Figure 1

trying to fix a system that has been badly, and to a large degree, irreparably damaged. There is simply no way to reconstruct the extraordinary loyalty of the huge core customer segment M&S once enjoyed, and replacement business will inevitably be more fragile and costly to sustain.

In spite of excellent information and scrutiny of intangibles, investors clearly had only a flimsy understanding of the implications for M&S's sustainable future earnings. What management and investors alike require, then, is a logical, rigorous, and reliable means of connecting information about intangible factors to the strategy of the business, and hence to its likely performance. When this strategic architecture is assembled, it becomes clear that three other pieces of information are necessary to understand performance before worrying about intangibles – information on additional *tangible* factors, on the *quality* (not just quantity) of those factors, and on the *rate at which they are changing*.

If we carefully take apart a firm's business model, it *is* possible to trace back from performance, through the substantive resources of the business system and the processes by which these change, until the impact of true intangibles is revealed. This is also valuable for managers themselves as it gives them a stronger grip on their strategy and performance. Unfortunately, such information not only helps investors assess a firm's performance, but also makes crystal clear to competitors the sources of its competitive advantage. So, once we have laid out what would be most helpful to investors, we need to balance the advantages of disclosure against the risks.

Assets, performance, and value

We should start by sorting out some language issues.

There is a common belief that intangible factors largely account for the difference between the value of the business to its shareholders and the reported financial asset value. Indeed, valuation language virtually defines intangible assets in these terms. This creates some strange results. Customers, for example, appear tangible to most people. Staff are pretty tangible, too, as are a product range, suppliers and distributors. Yet, the OFR, in common with much discussion about business performance, wraps them up in abstract terminology about "relationships" (although total employee numbers, at least, are recorded). It is clearly difficult, and of dubious validity, to put a financial value on these items, not least because they are not actually owned by the business. Even so, most reasonable businesses can reliably expect that staff who were with them last week will probably turn up on Monday morning, as will their customers.

If we are truly to understand the link from strategy to performance, we have no choice but to take account of these tangible, but impossible-to-value factors. At the same time, we have to avoid confusing people who are used to the normal terminology about intangible assets. So, from now on we will refer to these solid factors as *tangible resources*, along with other items, such as product range, production capacity, distributors and so on. They will be quantified, but in their own concrete terms (people, for example) not some financial alternative. They also exhibit the key characteristic of the tangible assets that do appear in the accounts – they must be built up and sustained through time.

Incidentally, strategy theory does not treat many of these resources as strategic, either because they are so transparent (and, as a result, allegedly cannot give any competitive advantage), or because they are not owned by the firm. For most businesses, though, having no customers equals having no business, so for practical purposes these items *are* resources, and important ones.

With this understanding of tangible resources, we can already see a vital gap in what the OFR suggests firms should be reporting, since it regrets the lack of statutory requirements to report on "the main **qualitative** factors which underlie past and future performance", but makes no mention of these →

→ other *quantitative* items. The idea that intangible factors alone account for the excess of business value over the disposal value of its physical assets has never been, even remotely, close to reality. It is as though we were trying to explain the value of a car by putting a price on the wheels, the engine, the seats, and so on, and if that doesn't add up, putting some extra value on its speed and road-holding. In reality, it is only when put together as an entire *system* that we have some recognisable whole that we can decide is worth the overall price we are prepared to pay.

Assessing value

When assessing a firm's value, shareholders consider expected future cash flows and decide what they feel these are worth (see Figure 1). Rarely does this valuation correspond to the disposal value of its tangible assets, and for very good reason – any real business relies on many other tangible resources that cannot, in any meaningful way, be valued.
To take a simple example, you might decide that consumers in a particular locality would appreciate the opportunity to eat out, then buy and develop a suitable property in order to turn it into a restaurant. You still don't actually *have* a restaurant, merely a building that looks like one. You only have a functioning restaurant business – with prospective cash flows – when you have hired staff, offered a menu, and won customers. Staff, products, and customers are, in addition to the physical real-estate, tangible resources of the business, but it makes no sense to try and ascribe a financial value to any of these items in isolation, only to the whole system. Consequently, those prospective cash flows need bear no relation whatever to the financial investment you put into the building and equipment.

What role do intangibles play in this situation? We have said nothing about staff skills, reputation, or brand – nor do we need to. Your restaurant may offer a quite ordinary menu, quite ordinary staff, and have no significant brand, yet still generate prospective earnings that are worth far more than the underlying assets. That excess value is due, not to intangible factors, but to the tangible resources that rarely receive proper attention, such as customers and staff (see Figure 2).

This notion of business performance and value reflecting a set of interdependent resources exposes a common fallacy – that total business value can be separately attributed to individual value drivers. If you remove any one of these assets, the business fails to generate earnings. It is the *system* that generates cash-flow and value, not the individual components.

So how much do investors get told about these tangible resources? Since capacity often consists of physical, inanimate assets that have to be bought or constructed for cash, it is not surprising to find these resources explicitly quantified in physical terms – infinitely more useful for understanding likely earnings than the *financial value* of capacity. We see good information about M&S stores, easyJet aircraft, BP oil reserves and refineries, and so on.

Capacity is not always so clear-cut. WPP, for example, one of the world's largest media services groups, relies on skilled professionals in advertising, PR, and branding. Yet simply knowing the number of such professionals that WPP employs tells us little of the organisation's capacity to win and serve clients, and hence generate revenue and earnings.

Companies in certain sectors report on customer numbers quite explicitly, e.g. subscribers to mobile phone operators or TV channels. M&S provides some information about the fraction of consumers who use its stores, and WPP provides good information about client numbers. However, in most cases, customer numbers are either not reported at all or are mis-reported.

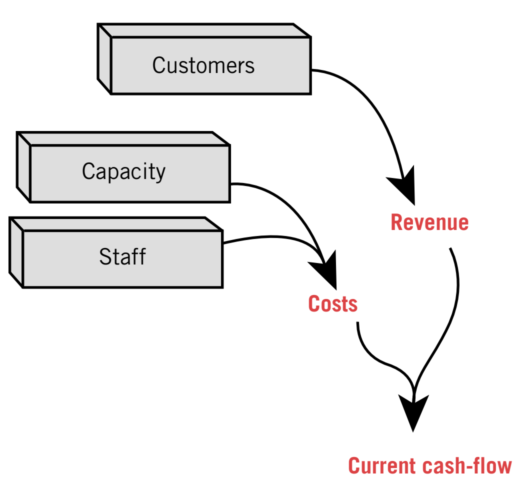

Figure 2

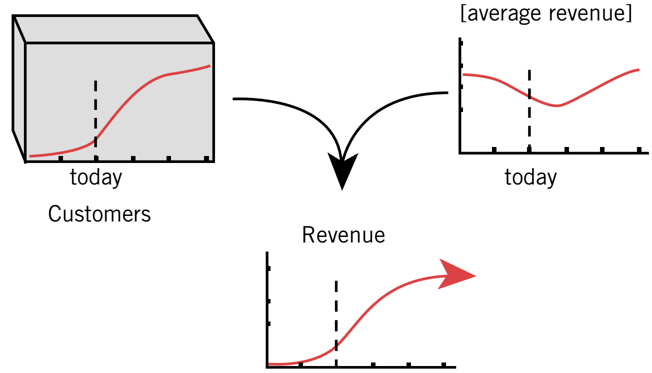

Figure 3

In the year ended March 2004, for example, easyJet reported that it carried 21.8 million passengers – except, of course, that it didn't. It flew 21.8 million passenger *journeys*, and we don't know if this was 21.8 million people who flew once, or 2.18 million who each flew 10 times.

Reporting customer numbers is not always straightforward. For example, many people have bank accounts they never use, so should not strictly be regarded as active customers. Nevertheless, it is generally possible to specify what constitutes a real customer and report accordingly. Management should certainly undertake some such assessment when developing strategy, so the information should already be available to well-managed firms.

Company reports have long given information on total employee numbers, but rarely specify the number of staff associated specifically with revenue generation, customer retention and so on. A key factor in the decline of M&S was a deterioration in customer service caused by draconian controls on numbers of front-line staff. Indeed, so badly was this misunderstood that the company was praised for achieving high levels of productivity – i.e. sales per employee - while in reality this was damaging the business.

Capacity, customers, and staff are not the only tangible resources investors need to be informed about. Product range and distribution, for example, are essential to understanding likely sales and earnings in consumer goods, business consumables, and other sectors. Yet few companies report adequately on these items.

Feel the quality

Enjoying large *numbers* of customers, staff, products and other assets tells us little about performance, if we know nothing about the *quality* of these resources (see Figure 3).

The retailer WH Smith, like M&S, can claim to serve a large fraction of British consumers. However, the company constantly struggles to sustain sales and profitability, because of a low average value from each customer visit. In contrast, TV broadcaster Channel Four has long understood that a premium audience can capture more spend from advertisers than an audience that is simply large. As a result, it has one of the highest quality audience profiles of any large broadcaster in the world.

In spite of the importance of asset quality in determining revenue and earnings, company reports provide little more than indicative evidence about this crucial issue. The best exceptions demonstrate how little investors know about most organisations. Mobile phone operators have long reported on subscriber quality through the metrics of average revenue per user (ARPU), and clearly scrutinise this metric in detail in steering their strategy, not just on average, but as it varies among important customer segments. The broadcasting company, BSkyB, also provides some information about the value of its subscriber base.

Issues of quality apply to all categories of tangible resources, with critical implications for business performance. The experience of WPP's professionals is vital, as is the take-up of their services by clients. We have already wondered about the travel frequency of easyJet's passengers, and investors may have moderated recent expectations, had they understood changes in the quality of its route network. Consumer goods suppliers report proudly on their range of products, but are reticent about how their popularity among the public varies, or their penetration into retail distribution. Retailers report on store numbers and size, but give little indication of the number of consumers these stores can reach.

Where are we going?

We have discussed only the role of tangible factors, and their quality, in determining *current* sales →

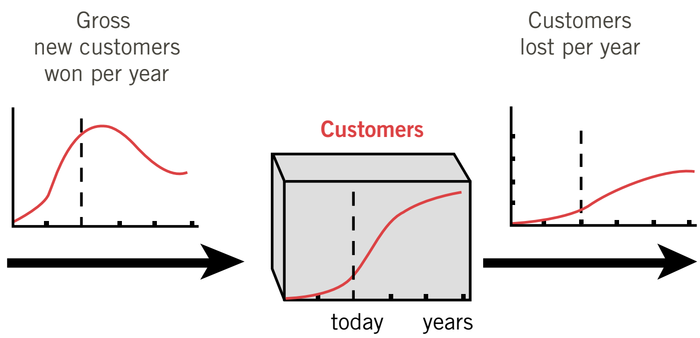

Figure 4

→ and earnings. But our original aim was to understand the likely *trajectory* of future earnings.Since today's assets explain today's revenues, costs and earnings, we need to know about likely *future* assets if we are to understand performance prospects. This requires information on *the rate of change* in those assets. This is both the most crucial – yet weakest – feature of business performance reporting.

Once again, good examples expose how little investors are typically told about this issue. BSkyB and telecoms firms report on subscriber churn rates, and Compass Group - the contract catering provider – reports on contract renewal rates. However, we are given little factual information about customer loyalty by firms in retailing, airlines, or many other sectors.

Rates of change are vital in regard to other tangible assets besides the customer base. Staff turnover is perhaps the clearest example. We might, for example, have anticipated falling service quality at M&S, had we known about attrition among demoralised store level staff. Professional firms, such as WPP, are particularly susceptible to staff turnover, but few provide information on this critical issue. Similarly, we need better information on product range changes in consumer goods, advertiser churn in media firms, and the rate at which retailers are refreshing their real estate by replacing poor units.

Knowing the *net* change in resources alone is not sufficient, however. If management are to understand likely future performance, they must understand *gross* additions and losses (see Figure 4). BSkyB, for example, added 510,000 subscribers in the year to June 2004 – except that it didn't – in fact, it added 1,160,000, but lost the rest to subscriber churn. This is an admirable, but rare example of open reporting about gross changes to resource levels, with important implications for future performance. BSkyB is aiming to reach 10 million subscribers by 2010, a goal that will be considerably more difficult

	Cash	Customers	Staff	Capacity	Products
Opening balance	Cash at start of year	Customers at start of year	Staff at start of year	Capacity at start of year	Products at start of year
Additions	Cash inflow	New customers won	New staff taken off	New capacity added	New products introduced
Losses	Cash outflow	Customers lost	Staff lost	Capacity closed	Products discontinued
Closing balance	Cash at year-end	Customers at year-end	Staff at year-end	Capacity at year-end	Products at year-end

Table 1 Cash-flow and resource-flow statements

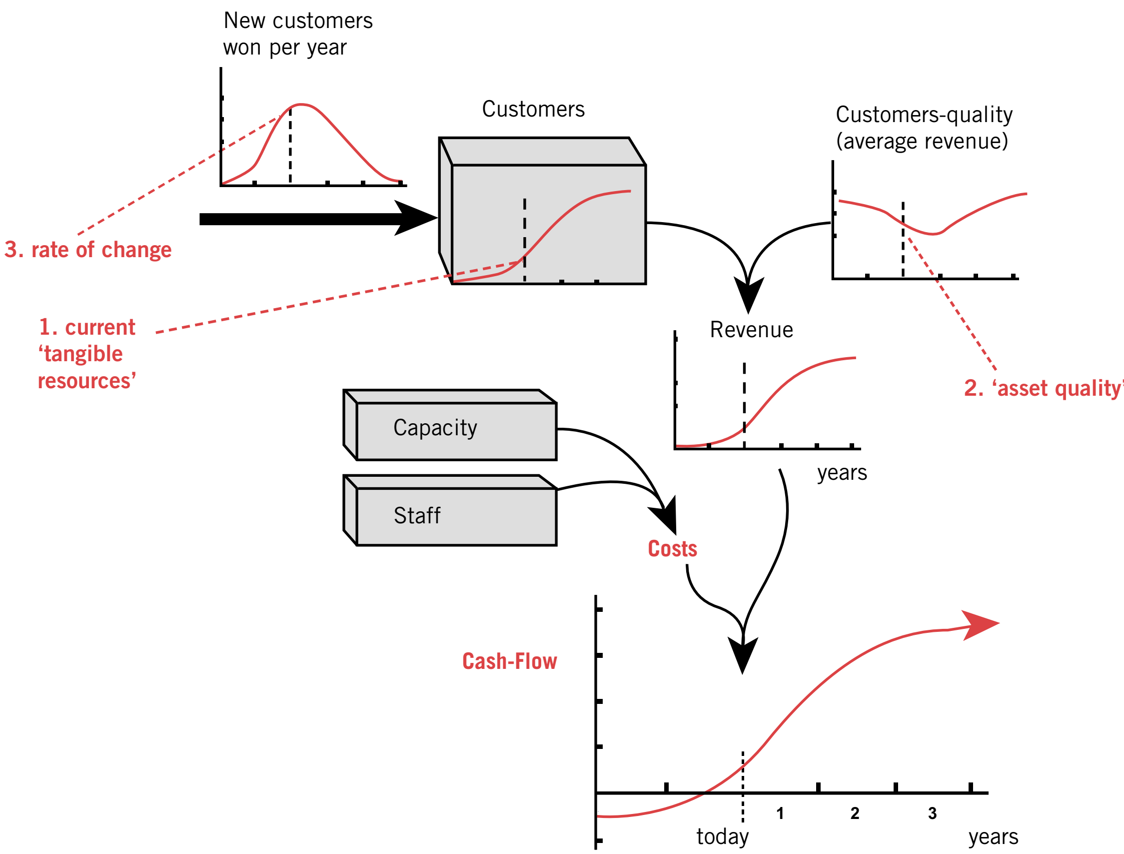

Figure 5

to attain if churn rates continue at about 10 per cent a year than if it slows substantially.

Reporting resources and their rates of change is not really so big a stretch, since it has an exact analogy in the balance sheet and cash flow statements. We expect to see cash-flow statements, but we need staff-flow, customer-flow, and capacity flow statements as well if we are to assess future performance.(see Table 1).

Putting the picture together

Now we have the key pieces of the causal explanation for performance, we can return to our original purpose - explaining performance through time, and anticipating where that performance might be heading into the future. Figure 5 shows how the three key pieces of information – tangible resources, their quality, and rate of change – combine to determine performance prospects. Only the connection between customers and revenue is made explicit here; similar clarity about the quantity, quality, and rate of change for staff, products, distributors, and other tangible factors will be needed if investors are to have a clear sense of any firm's future performance.

This picture is further complicated by the interdependencies among these tangible resources. The customer win-rate will reflect, for example, the numbers and quality of staff available, and the capacity of the organisation to serve those customers. This further undermines efforts to ascribe value to any particular resource or policy – the impact on cash flow from hiring another person, adding a new product, marketing to a new customer, or increasing capacity depends on the current state of existing resources. Adding one more customer could even destroy value, for example, if it damages service to those we already have.

What about intangibles?

Although we have covered a wide range of factors on which management and investors alike need information if they are to understand business performance and value, we have not yet considered where intangibles are involved. They do not appear on the balance sheet (and it is futile to try to put them there), nor are they directly correlated with the tangible assets on which cash flow depends – knowing M&S' service quality or reputation does not tell us how many customers it has. This knowledge does, though, tell us about the likely *rate of change* in those customer numbers. Poor service today encourages customer *losses*, and a poor reputation will likely depress the →

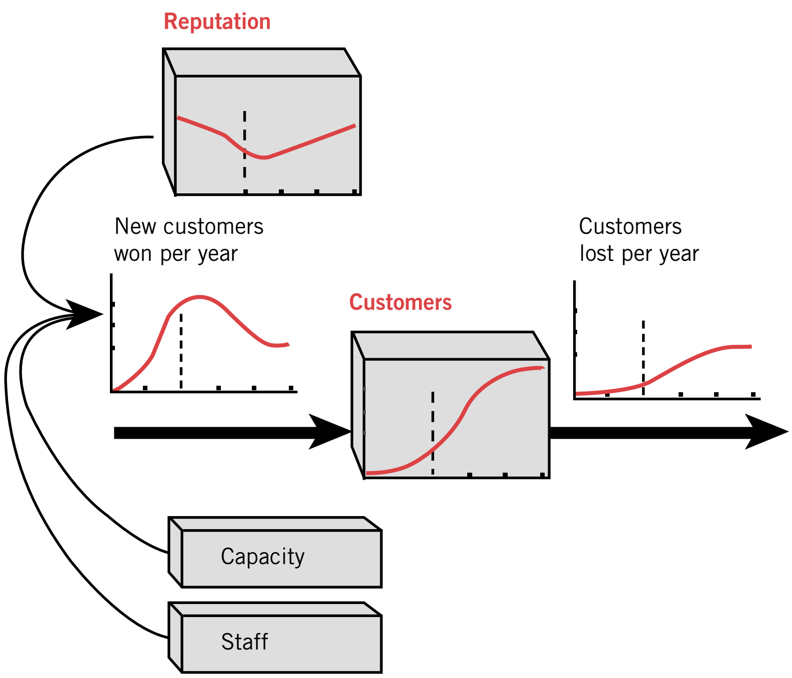

Figure 6

→ customer *win-rate*. This influence is additional to the direct effect caused by tangible resources – customer win-rates reflect *both* the number of sales people a company has *and* its reputation for quality and service (see Figure 6).

Other intangibles also work by influencing the gains and losses of tangible assets. Skilled technical staff increase the rate at which good new products can be launched, distributors are won to brands that are well-regarded, and staff turnover is faster when morale is poor.

Generically, we can lay out the causal logic connecting intangible resources, through changes to the tangible resources and their quality, through to performance (see Figure 7). Only if investors have *both* good information on these items and how they are changing, *and* a solid understanding of how the interdependencies work, will they be able to make a well-informed judgement about the growth potential and sustainability of the businesses. They should certainly expect that managers have such an understanding of the strategy of their organisations.

Certain firms have a strong grasp of these dependencies on intangible factors. Barclays Bank, for example, has excellent insight into the relationship between service quality, customer perceptions, and loyalty. Major pharmaceutical firms understand deeply how the support of key opinion leaders among medical specialists drives uptake of their products in the wider market. But confident, rigorous information and analysis of this kind is exceptional, and balanced scorecards used by firms are typically vague about the interdependencies involved.

Investors, then, are quite right to expect management to show a professional grasp of intangible factors. However, unless they *also* have information about the full range of tangible assets, the quality of those assets and the firm's ability to build, develop, and retain those assets, they stand little chance of estimating the strength of its strategy, its likely performance prospects, and hence its value.

To disclose or not?

While investors might welcome complete transparency about the resources and performance of the businesses they support, managers are naturally nervous about exposing the details of their strategic architecture to potential attack by competitors.

Yet, there may still be a persuasive case for greater openness. M&S declared outstanding operating profits from 1995 to 1998. Indeed, just about every financial fundamental was believed by analysts to be exemplary – margins, productivity, asset utilisation, etc. As we noted earlier, though, customer acquisition and retention were both in trouble and the intangibles were falling apart. How might analysts have reacted, had the company said in 1995 that it would be investing £200 million every year to enhance quality, service, and value, and back that up with evidence to show how essential that investment had become? Would management *really* have been criticised for such a stance? Would predators *really* have seen the company as a wounded animal, and had a credible case for taking it over?

It can even be competitively advantageous to be

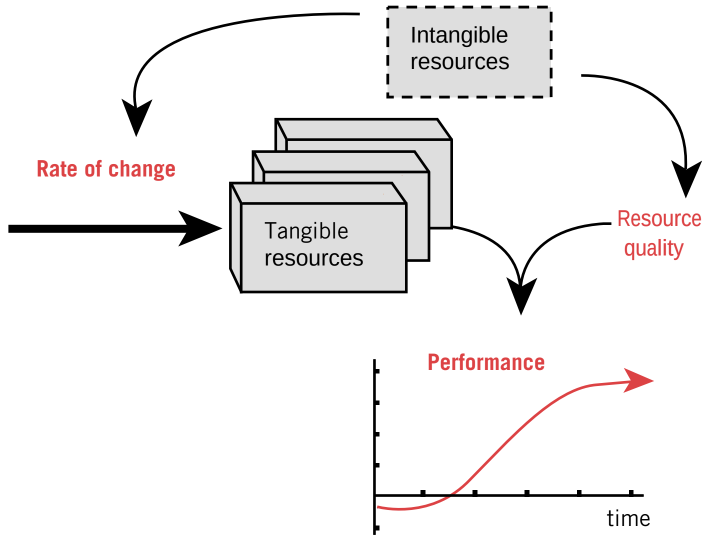

Figure 7

open about your strategic architecture and why it performs as it does. Sector after sector is bedevilled by companies with a limited grasp on strategic management, but which still think they can perform by pursuing simplistic policies. Unsustainable discounting with excessive marketing in many financial service markets is currently a case in point. Firms led by professional strategic management can show just what it takes to perform strongly, and thereby discourage foolish behaviour by less competent rivals and would-be newcomers.

There is a further reason why management might choose more openness. Shortly after the 1999 stock market collapse, which many of us should have seen coming, I asked an audience of investment analysts what it might have been worth to know, two years ahead of time, that a company would be in trouble. Their view? They would have preferred the information to remain undisclosed, since it would have lost them four half-year opportunities to exploit the misunderstanding and push management into pursuing earnings increases, even though those increases were both unsustainable and certain to destroy the integrity of the firm's strategic architecture. A cynic might even wonder if they were looking forward to making yet more money as the share price collapsed, and perhaps more again when takeover speculation started. A greater degree of openness by management about the true state and prospects of their business could just give them, and their long-term investors, some protection against this kind of short-term manipulation. ■

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