CORPORATE FINANCE FOR LONG-TERM VALUE

Chapter 17: Reporting and investor relations

Part 5: Corporate financial policies

Chapter 17: Reporting and investor relations

The BIG Picture

- Financial reporting is a means of communication between corporate management and the company’s stakeholders, including investors

Discussion

- Companies issue several financial statements, like a balance sheet, a profit & loss account and a cash flow statement -> informs investors on **financial** performance
- Impact reporting can inform stakeholders about **social** and **environmental** factors
- Integrated reporting is about understanding how a company creates integrated value and how its activities affect the capitals it relies upon for this
- Investor relations presentations are expanding to social and environmental information in addition to financial information

Financial reporting

- Financial reporting is valuable for communication with the outside world, including modelling by analysts
- Intangible assets, social value, and environmental value are gaining importance but are rarely shown in financial statements
  - Addressed through regulation: only public companies and large private companies
- Over the centuries, accounting has become increasingly sophisticated to facilitate better decision-making, external monitoring and more complex transactions

Reporting standards

- *Generally Accepted Accounting Principles* (GAAP) were developed to make reporting across companies more comparable ← **used by U.S. companies**

- *International Financial Reporting Standards* (IFRS) are issued by the International Accounting Standards Board (IASB) ← **used by non-U.S. companies**

- Eccles and Saltzman (2011) claim that financial reporting has institutional legitimacy, due to:
  - Measurement, reporting, and auditing standards
  - Effective enforcement mechanisms
  - Sophisticated internal control and measurement systems
  - Information technologies allowing for rapid capture and aggregation of data

Limits to financial reporting

- Difficulty in dealing with diverse user needs
- Poor comparability
- Backward looking vs forward looking needs
- Focused on manufactured & financial assets, not intangibles
- Inconsistencies in regulation
- Focus on compliance

Financial statements

- Financial statements give users insight into a company’s financial position and performance

- Consist of:
  - Balance sheet
  - Income statement
  - Cash flow statement

- *Materiality* is the degree to which certain issues are important for a company
  - The need to disclose individual items or groups of items separately depends on the **nature** and the **amount** of the item

Financial statement analysis

- *Financial statement analysis* is the process of reviewing and analysing a company's financial statements by external stakeholders
  - Calculation of financial ratios to gain insights in the company's ability to generate value
- Internal stakeholders use more detailed internal reports to monitor and improve efficiency, and to provide the basis for external reporting
- Five categories of financial ratios:

Profitability ratios	Liquidity ratios	Leverage ratios	Efficiency ratios	Valuation ratios
• EBIT margin • Gross margin • Return on assets (ROA) • Return on Equity (ROE) • Etc.	• Current ratio • Quick ratio • Interest coverage ratio • Etc.	• Debt-to-assets • Debt-to-equity • Etc.	• Asset turnover • Inventory turnover • Etc.	• Price-earnings • Market-to-book • Etc.

Balance sheet

- The balance sheet, or statement of financial position, lists a company's assets and liabilities
  - The difference between assets and liabilities is a company's net worth (equity)
- The *net working capital* is the capital available in the short term to run the business:
  - Net working capital = current assets – current liabilities

Inditex Group

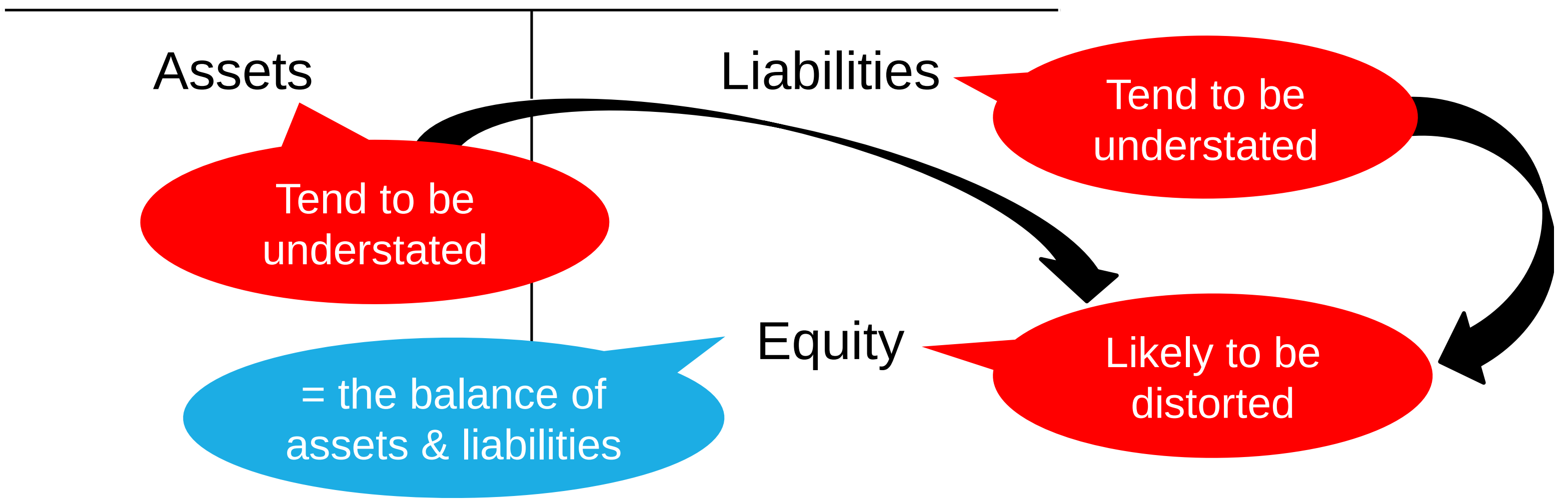
Consolidated balance sheet

(amounts in millions of euro)

Assets	2020	2019	Liabilities and equity	2020	2019	
Long-term assets	**15,460**	**16,977**	**Long-term liabilities**	**5,529**	**6,136**	**Maturity over one year**
- Property, plant and equipment	7,401	8,355	- Long-term debt	3	6	
- Investment properties	282	270	- Deferred taxes	396	370	
- Intangible assets	6,122	6,660	- Provisions	252	217	
- Other long-term assets	1,656	1,692	- Other long-term liabilities	4,879	5,543	
Current assets	**10,957**	**11,414**	**Current liabilities**	**6,338**	**7,306**	**Maturity of one year or less**
- Inventories	2,321	2,269	- Short-term debt	11	32	
- Accounts receivable	972	954	- Accounts payable	4,747	5,585	
- Other current assets	266	3,411	- Other current liabilities	1,579	1,689	
- Cash	7,398	4,780	**Equity**	**14,550**	**14,949**	**Book value of equity**
			- Issued share capital	94	94	
			- Share premium	20	20	
			- Retained earnings	14,703	14,993	
			- Other reserves	(267)	(158)	
Total assets	**26,418**	**28,391**	**Total liabilities and equity**	**26,418**	**28,391**	

Balance sheet distortions

- The balance sheet gives an incomplete picture of a company's equity value:
  - It reflects the shareholders' investment in the company
  - Several assets (i.e. buildings) are at historical cost net of depreciation
  - Several intangible resources (i.e. brand value) are not capitalised
  - Many valuable assets and liabilities are not on the balance sheet (i.e. human capital)



Market value of equity

- The book value of equity is likely to deviate from the market value of equity
- The *market value of equity* is a company's market capitalisation and depends on what investors expect a company's assets to produce in the future

Market value of equity = Shares outstanding x Market price per share

Problem: Inditex has 3.1 billion shares outstanding at € 26.4 per share on 31 December 2020.

What is Inditex's market cap(italisation)? How does it compare to its book value in 2020?

Solution: Inditex's market cap: 3.1 billion shares x € 26.04 = € 82.1 billion

Inditex's book value of equity is € 14.6 billion (see previous slide), so market cap is far higher

Market to book ratio

- The market to book ratio (or price to book ratio) is a valuation metric used to evaluate a company's current market value relative to its book value:

$$\text{Market-to-book ratio} = \frac{\text{Market value of equity}}{\text{Book value of equity}}$$

- The difference between market value and book value reflects expected abnormal or residual profitability
  - A market-to-book ratio above one suggests that the company is expected to generate residual profits in the future
- Inditex's market to book ratio is €82.1 billion / €14.6 billion = 5.62
  - Interpretation: investors are prepared to pay 5.62 times the amount of Inditex's book value per share

Income statement

- The *income statement*, or profit and loss (P&L) account, lists a company's revenues and expenses
- The key metrics are:
  - Earnings before interest and taxes (EBIT)
    - EBIT = Revenues – Expenses - Depreciation
  - Net profit
    - Net profit = Revenues – Expenses – Depreciation – Interest payments - Corporate tax
  - Earnings per share
    - Earnings per share = Net Profit / Number of shares outstanding

Inditex Group
Consolidated income statement
(amounts in millions of euro)

	2020	**2019**
Sales	20,402	28,286
Cost of sales	(9,013)	(12,479)
Gross profit	**11,390**	**17,806**
Operating expenses	(6,838)	(8,209)
Depreciation and amortisation	(3,045)	(2,826)
Operating profit (EBIT)	**1,507**	**4,772**
Financial results (interest income/expense)	(106)	(91)
Profit before taxes	**1,401**	**4,681**
Corporate tax	(297)	(1,034)
Net profit	**1,104**	**3,647**
Earnings per share	**€ 0.355**	**€ 1.168**

Cash flow statement

- The balance sheet and income statement can be influenced by management to smooth profit over the years
- The underlying cash flows are not sensitive to accounting policies ← **cash does not lie**
- The cash flow statement has three sections:
  - Cash from operating activities
  - Cash from investment activities
  - Cash from financing activities
- Differences between income statement and cash flow statement are usually caused by depreciation

Inditex Group

Consolidated cash flow statement
(amounts in millions of euro)

	2020	**2019**
Operating activities		
Net profits	1,401	4,681
Depreciation and amortisation	3,045	2,826
Other non-cash items	(582)	(811)
Cash effect of changes in working capital		
Inventories	93	201
Accounts receivable	34	(10)
Accounts payable	(974)	14
Cash from operating activities	**3,017**	**6,900**
Investment activities		
Capital expenditures	(672)	(1,112)
Acquisitions	(5)	-
Other investment activity	3,191	(1,264)
Cash from investment activities	**2,514**	**(2,377)**
Financing activities		
Sale (or purchase) of stock	-	-
Changes in debt	(23)	(52)
Dividends paid	(1,090)	(2,741)
Other financial activities	(1,673)	(1,836)
Cash from financing activities	**(2,786)**	**(4,629)**
Change in cash and cash equivalents	2,745	(106)
Cash at beginning of the year	4,780	4,866
Effects of exchange rates on cash	(127)	20
Cash at the end of the year	**7,398**	**4,780**

Audits

- Publicly listed companies are required to have their financial statements reviewed or audited by an auditor
- An *auditor* is a chartered accountant that is qualified to audit financial statements
- The auditor’s objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement and to issue an auditor’s report that includes the auditor’s opinion
- There are two levels of audit assurance:
  - **Reasonable assurance**, a high level of assurance, but not a guarantee
  - **Limited assurance**, a lower level of assurance, but sufficient to form conclusions

Big Four accounting firms

Audits

- The auditor evaluates the appropriateness of accounting policies applied and the reasonableness of accounting estimates made by a company's directors

- The *going concern principle* assumes that during and beyond the next reporting period a company will complete its current plans, use its existing assets and continue to meet its financial obligations

- The auditor's opinion is the main instrument for an auditor to inform financial statement users about his findings:
  - **Unmodified opinion**: the auditor concludes that financial statements give a 'true and fair' view of the company
  - **Modified opinion**:
    - **Qualified opinion**: given when misstatements are material but not pervasive
    - **Adverse opinion**: given when the auditor concludes that misstatements are both material and pervasive

Accounting scandals

- The collapse of Enron in 2001, the largest corporate bankruptcy at the time in American history, involved the use of accounting loopholes, special purpose entities, and poor financial reporting
  - Management of the energy company was able to hide billions of dollars in debt from failed deals and projects, inflating Enron's accounts and performance
  - Enron's bankruptcy led to the closure of its accountant, Arthur Anderson, which was found guilty of illegally destroying documents relevant to the SEC investigation

- Another scandal concerned Germany company Wirecard
  - Allegations of accounting malpractices culminated in 2019 when the Financial Times published whistle-blower complaints and internal documents
  - In June 2020, Wirecard filed for insolvency after revealing that €1.9 billion was missing, and the arrest of its CEO
  - Questions were raised about regulatory failure of the German supervisor, BaFin, and possible malpractice of Wirecard's long time auditor EY

Investor relations

- The investor relations (IR) department at a company informs current and prospective investors about the company's financials, strategy, operations, etc.
- Responsibilities include:
  - Publishing financial reports and other externally oriented material
  - Organising meetings with investors and presenting the company

Typical points made in an IR presentation:

- Pitch: why invest in this company?
- Key products and markets, the company's competitive edge & challenges
- Looking back: recent earnings history, product introductions, macro/market environment & actions
- Looking forward: plans, prospects for growth or cost cutting

BMW investor slide

- BMW starts their presentation by asking and answering: why invest in BMW?

FIRST-CLASS INDIVIDUAL MOBILITY – We play a **pioneering role** in setting standards for the individual **premium** mobility of tomorrow. It **combines pleasure and responsibility** without compromise

SUSTAINABILITY – The BMW Group is a **holistically sustainable company** taking **responsibility for sustainable future mobility.** Every investment in BMW is a **sustainable investment.**

INNOVATION & FLEXIBILITY – The MBW Group is an **innovation pioneer** in the automotive industry. Our business model is based on **constant transformation** and **flexibility** – successful for over 100 years.

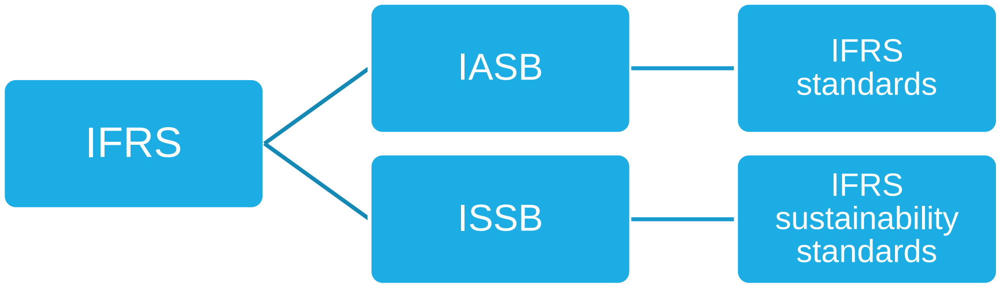
ELECTRIFICATION – Due to our **flexibility** and **permanently transformed plants,** we will have a **convincing battery-electric vehicle** offer **covering 90%** of our current market segments from 2023.

DIGITALISATION – We set standards in the **digitalisation** and **connectivity** of our vehicles and use our **competitive edge in remote software upgrades.**

FINANCIAL PERFORMANCE – We offer **financial stability** due to our strong **balance sheet** and industry-leading **credit ratings.** We set **ambitious profitability** and **cash flow targets** and are a **reliable dividend payer**.

Sustainability-related financial reporting

- Sustainability reporting is in transition
  - In 2021, the International Sustainability Standards Board, a new body of the IFRS, consolidated several voluntary reporting initiatives:
    - Task Force on Climate-related Financial Disclosures (TCFD, 2017),
    - Sustainability Accounting Standards Board (SASB)
    - Integrated Reporting (<IR>)
- The IFRS now has two bodies:
  - International Accounting Standards Board (IASB)
  - International Sustainability Standards Board (ISSB)



- New IFRS sustainability standards are mandatory, part of financial reports and subject to audit control
  - Contains disclosure requirements for sustainability information relevant for the company’s financial value (inward)

IFRS S1 and S2

In 2023, IFRS issued 2 standards:

- **IFRS S1**: General Requirements for Disclosure of Sustainability-related Financial Information
  - Sets the general framework for disclosure of sustainability risks and opportunities related to the company's financial value
  - Requires that company shall provide disclosure about:
    - **Governance** procedures used to monitor and manage sustainability risks and opportunities
    - **Strategy** for addressing material sustainability risks and opportunities
    - **Risk management** used to identify, assess and manage sustainability risks
    - **Metrics and targets** used to assess, manage and monitor the company's performance
- **IFRS S2**: Climate-related Disclosures
  - More detailed requirements for the disclosure of several climate topics
  - Report in relation to the planetary boundaries of climate change (1.5ºC, 2ºC or 3ºC limit)

Material topics per industry

- SASB Standards vary by industry, based on the different sustainability risks and opportunities within an industry
- SASB categorises 77 industries, the material topics for three industries are presented below:

Apparel, Accessories & Footwear	Hotels and Lodging	Materials & Mining
• management of chemicals in products • environmental impacts in the supply chain • labour conditions in the supply chain • raw materials sourcing	• energy management • water management • ecological impacts • labour practices (including average hourly wage) • climate change adaptation	• GHG emissions • air quality • energy management • water management • waste & hazardous materials management • biodiversity impacts • human rights (including those of indigenous people) • community relations • labour relations • workforce health & safety • business ethics • tailings storage facilities management

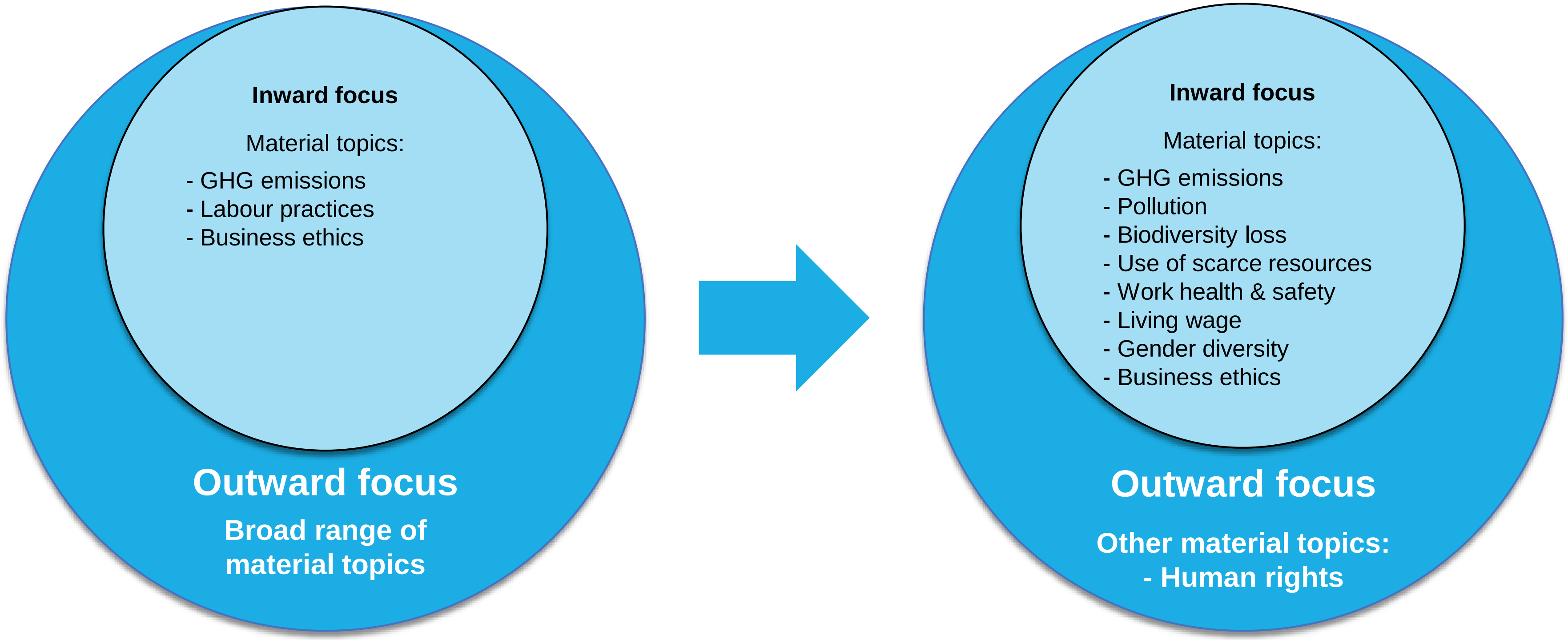
Some industries have more material topics than others

Sustainability reporting – case study

- AkzoNobel, a large Dutch paints and coatings manufacturer, provides an example of voluntary reporting on social and environmental topics in its annual report
- Under the headings People, Planet and Paint, AkzoNobel provides detailed numerical information on material topics, including some targets for 2025
  - Social topics include work health and safety, gender diversity, and community training
  - Environmental topics include carbon emissions, waste, and fresh-water usage
- In line with best practice, AkzoNobel does not only provide information on its own operations, but also on its contractors in the supply chain and its products
- While AkzoNobel's reporting is advanced, it still does not give sufficient information to assess the company's value creation and destruction for society and nature

Convergence in reporting

- Convergence from voluntary to mandatory reporting is needed to enable comparability
- Similarly, convergence of financial and impact materiality is occurring, mostly because outward issues are increasingly seen as inwardly relevant as well



Impact reporting frameworks

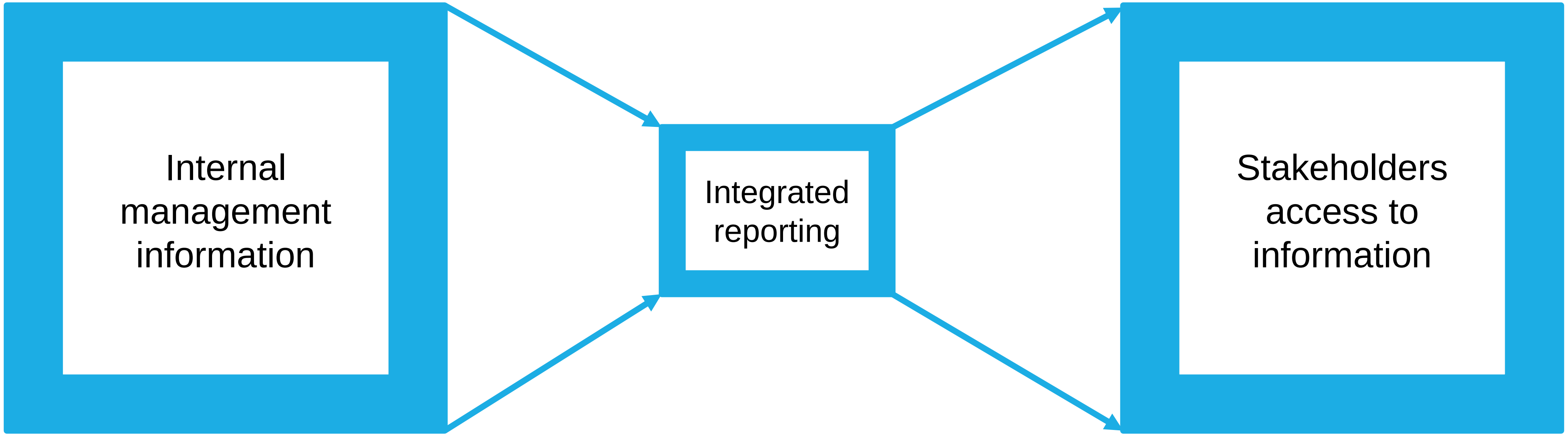
- The major emerging impact reporting frameworks, which are all voluntary, include:
  - **Integrated Capitals Assessments**
  - **Impact-Weighted Accounts Framework (IWAF)**
  - **Value Balancing Alliance (VBA)**
- Impact frameworks make use of four capitals: financial, social, human and natural capital

Basics of impact reporting

Identification of material impacts across value chain	Reflect current and future value enjoyed by stakeholders
Measurement of impact	Using a baseline or reference
Comparability - valuing in common currency	Reflects the true price of social and environmental factors
Aggregation of impact within welfare categories	While remaining conscious of the elements being aggregated
Attribution of impact across value chain	Double counting of impact should be avoided
Presentation of impact statement	Presents a company’s value creation and reduction

Integrated statements

- Internal management information systems contain a wealth of information, of which only a small subset is externally reported
  - This externally reported data is just a subset of the total body of externally available data about the company’s performance: complemented by data from NGOs, researchers, consultants, etc.



Producing integrated statements

- While accounting records past transactions in company financial statements (backward-looking), finance tries to assess the effect of future events (forward-looking)
- Integrated profit & loss (IP&L) statements show what happened last year and registers the revenues, expenditures and impacts over this period
  - Main challenges: revaluation of assets and reorganisations
- Compiling an integrated balance sheet is more challenging
  - There is a big tension between the historical value or cost-price of assets, and the forward-looking earning power of assets
- The aim of integrated reporting is to inform stakeholders, allowing them to form a balanced opinion on the “value” of the company

Integrated audits and investor relations

- Currently, there is lack of relevant auditor skills and international standards are still in the process of being adopted for integrated reporting
  - European Sustainability Reporting Standards (ESRS) require limited assurance for the first years of implementation (from 2024/2025) and reasonable assurance thereafter
- Integrated IR means that the IR role is expanded to inform investors on the company's value creation on E, S, and F

Typical points made in an integrated IR presentation

- Pitch: why invest in this company? How does it create value on E, S and F?
- Key products and markets, the company's competitive edge & challenges. What value creation on E, S and F look like per business unit and how they interact
- Looking back: recent value creation history on E, S and F, product introductions, macro/market environment & actions
- Looking forward: plans, prospects for growth or cost cutting, how to achieve better value creation on E, S and F

Conclusions

- Financial reporting is a means of communication between corporate management and the company’s stakeholders, including investors
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