Is everything that counts being counted?

Building a new perspective on value creation for all

The better the question. The better the answer.
The better the world works.

EY
Building a better working world

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Introduction

At a time of activist investors, the 24-hour news cycle, and quarterly reports, CEOs and boards are under increasing short-term pressure and many are struggling to communicate the long term value that they are creating for all of their stakeholders.

Through our conversations with academics, investors and business leaders, we believe that this situation is the result of four key drivers:

- The shape of value is changing and an increasing proportion of a company's value lies in its intangible assets but traditional financial reporting metrics were not designed to measure them
- The trust gap between business, the establishment and society is widening
- There is pressure in the investment chain to focus on the short-term despite the desire to create value in the long-term, and
- The proliferation of data is providing new ways of measuring value but also means organisations are increasingly losing control over the conclusions made about their business

In order to respond, businesses need to be able to measure and demonstrate how the implementation of their strategy is delivering long term for all their stakeholders. However, building consensus and trust between businesses and investors on all the measures that matter is a challenge. In the UK, regulatory authorities are already moving to regulate in this area and this underlines how important it is to have asset creators (i.e. companies), owners, and managers at the table right now, creating a shared, market-led solution.

If we want to catalyse change, we need to be measuring the factors that reflect the creation of value – not just what regulators want to see. Investors need comparable verified outcome metrics to evaluate which companies are positioned well for real long-term success.

That is why we are working with asset creators, owners, and managers as part of the Embankment Project for Inclusive Capitalism. This project began at a meeting convened by Lady Lynn Forester De Rothschild founder of the Coalition for Inclusive Capitalism and hosted at the Unilever offices on the Embankment in London. Ten CEOs from across fund managers, corporates and pension funds discussed EY's long term value framework and made a commitment to join a project led by the Coalition for Inclusive Capitalism to explore the outcome metrics further.

With over 30 leading organisations representing almost $28 trillion of assets now involved in the project, we believe that by identifying a consistent set of metrics, we will increase transparency in the investment value chain which will help companies to more effectively articulate how they create value for their stakeholders and reduce the pressure to make short-term trade-offs. Ultimately it is about helping companies to deliver trusted, relevant information to their key stakeholders and help improve the allocation of capital for the long term – creating a shared future for all.

The four drivers at a glance

The changing shape of business value

Our financial reporting system was created in an industrial age - a time when physical assets made up the core of a company's balance sheet. Now, the growth of the knowledge economy means that more and more of a company's value lies in its intangible assets such as its brand, research and development and intellectual property.

Businesses are therefore often not giving a true account of their value and performance, and stakeholders are lacking the information to truly understand the business's future potential for value creation. Some of the asset managers and asset owners we have spoken to have told us that this inconsistency in models and metrics, inhibits their ability to use the information.

Undisclosed intangible value rose annually by **18%** from 2011

2017 Edelman Trust Barometer

Intangible assets represented 17% of market value in 1975 and by 2015 have risen in some sectors to **87%**

2017 ICAEW

52% of market value is based on intangibles on average

2017 Global Intangible Finance Tracker

The investment disconnect

Without the full picture of a business's performance, investors and other stakeholders tend to focus on the small, narrow part to which they have access. This contributes to an investment chain that tends to focus on the short term. In addition, performance pressures on fund managers can also sometimes drive a short term focus and disconnect with the long term aims of the actual share owners.

Pressure to demonstrate strong financial performance within two years rose from 79% to **87%**

2016 FCLT Global

The failure of investors to take a long-term view is inhibiting investment

2017 UK Government's Patient Capital Review

1t USD unlocked value by companies unable to take a longer-term approach in forgone US GDP alone over the past decade

2017 MGI

The widening trust gap

It is widely acknowledged that confidence in business has failed to recover since the financial crisis. While it would be too simplistic to attribute the "trust gap" wholly to shortcomings in current financial reporting, a lack of transparency around company reporting is contributing to the sense of disconnect.

The current financial reporting system is skewed towards short-term financial performance, and doesn't help companies to communicate how they're creating value for the long term.

Only **43%** of the general public trust business compared to 45% in 2017

2018 Edelman Trust Barometer

When asked for their reasons for distrusting business, **45%** of respondents say businesses do not operate in an open and transparent way

2018 Edelman Trust Barometer

60% of respondents believe CEOs should lead change rather than wait for regulators to impose it

2018 Edelman Trust Barometer

The proliferation of data

Never before has so much information been publically available about businesses and their employees. On one hand this provides a rich source of data, which can be mined by companies to help build a better understanding of their intangible assets such as their corporate culture. On the other hand it means organisations are increasingly losing control over the conclusions made about their business, with investors no longer limited to the information available in the annual report. Investors are increasingly prepared to make their own judgements, based on the information they can glean for a range of resources and the ability to mine data is becoming increasingly sophisticated.

IP traffic will grow at a CAGR of **24%** from 2016 to 2021

2017 CISCO

Investors seek an advantage from tradable intelligence – worldwide revenues for big data and business analytics will this year reach **150b USD**

2017 Financial Times; IDC

64% of people say they find leaked information more believable than press statements

2017 Edelman Trust Barometer

Understanding the disconnect

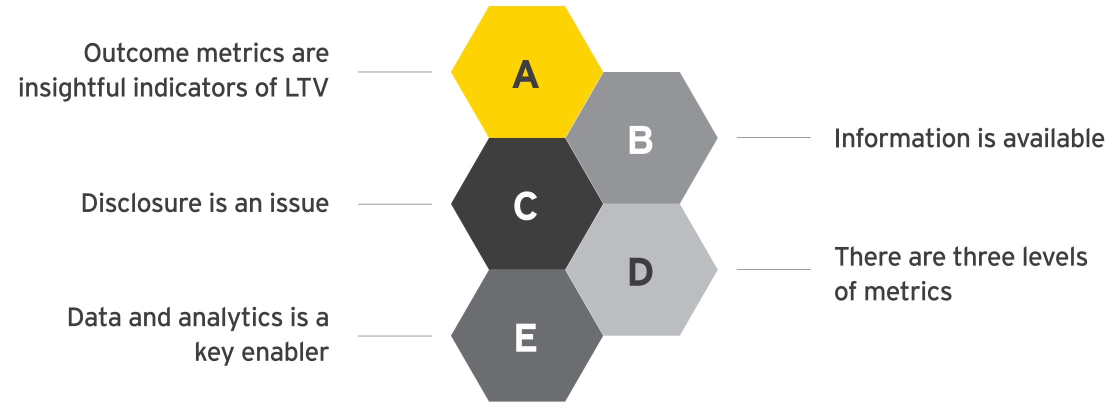
We have already highlighted the four key drivers to better demonstrate how a company creates long term value.

Without a proactive response to these challenges, there is every chance that the disconnect between asset creators, asset managers and asset owners will continue to widen. It is certainly safe to say that the proliferation of data will become magnified and the ability of businesses to control their own long term value story will diminish as a result. We also believe that it may only be a matter of time before Governments respond to public opinion with greater regulatory burdens. Rather than wait for this to become a reality, we believe that it is time to seize the initiative by developing a measurable and transparent way for companies to better articulate their long term value narrative.

Our discussions with asset creators, managers and owners have shown that the issue of duration is a key factor. For example, in many cases the alignment of the time period for executive performance measurement in relation to the need and obligations of entities is out of step. Added to this, the need for accountability and a lack of information on which to value long-term investments encourages a focus on short term financial metrics by managers. In turn, managers are required to deliver according to the mandates set by the owners, which are often articulated around short-term financials.

In response to all of this, we believe that the identification of a consistent set of outcome metrics that will measure significant areas of value creation, beyond purely financial value, will form the foundation of the way forward.

The hypotheses



This does not necessarily require the building of new approaches to calculating relevant metrics as it may be that what already exists can be adapted. Instead it means taking a deeper look at the non-financial metrics that will be of value to asset managers and owners – whether they represent human, consumer or societal value – and pioneering new ways to measure and compare the defined set of stakeholder outcomes.

With all this in mind, we set out a hypothesis against which to test our thinking with a range of stakeholders:

A. A consistent set of agreed outcome metrics would provide an insightful indication of long term value creation. However, it is crucial that investors buy into the validation of these measures. If not, they risk becoming shelved as just another piece of data while other factors are used to actually inform decisions. In other words, if we want this work to be more than a theoretical exercise, it needs to reflect the things people really value in the real world. It is for this reason that we have been long-time supporters of a market-led solution.

B. In many cases, the information to inform those metrics is already available. Only in cases where there are not widely accepted and appropriate metrics should new ones be developed. And to build on this, we advocate an open-source approach that facilitates adaptation of metrics as situations change rather than creation of new ones.

C. Greater disclosure is not necessarily the answer because investors may not have confidence in the robustness of information disclosed or its link to value creation. There may also be a sense that management is cherry picking the key messages. What investors are really looking for is better quality, more reliable and more comparable information. This means that rather than an increase in volume, we need specific, certifiable information that more fully captures a company's long-term profitability.

D. The most relevant metrics may be different for different scenarios but there are essentially three levels: universal metrics that are common to all sectors, sector-specific metrics that give investors a sense of how a company is positioned relative to others in its industry and company-specific metrics that take a bespoke look at how a company has tried to create long-term value based on their purpose and social intentions.

E. The ability to analyse data and draw insights will be a key enabler in the long term value journey. It can help enable companies to measure and express the value of their intangible assets, such as an organisation's culture, by looking at a whole range of different factors. Analytics can also provide the means to assess and articulate the long term value of potential business opportunities. By utilising data in this way, companies can retain control of their equity story.

A new direction?

The need for change is clear but how do we build on existing financial reporting frameworks to better articulate to the financial markets how value is created?

Over the last two years, we have been developing a new reporting framework to address some of these important issues and help companies to better measure and report the long term value they are creating for their stakeholders.

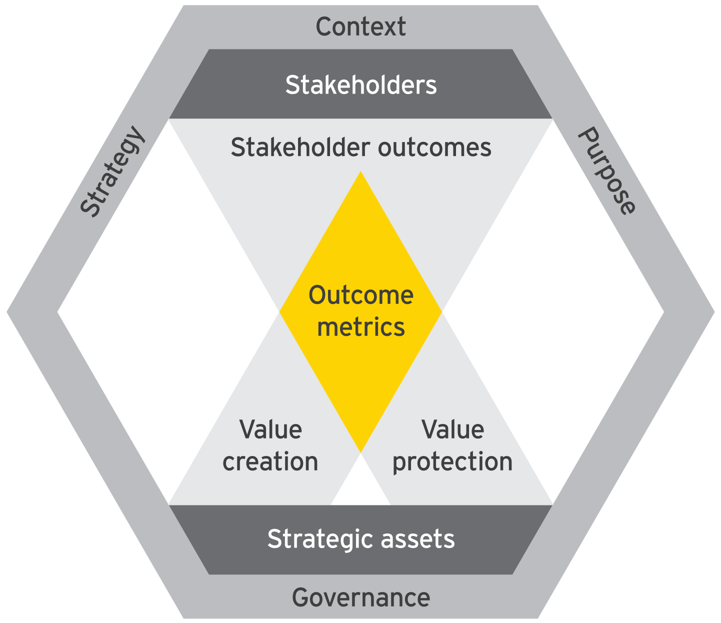
Working with Cambridge University, other leading academics, investors and business leaders, we published the results of our work in a white paper at the end of 2016.

Soon after that, the Embankment Project for Inclusive Capitalism was formed with the aim of developing a measurable, comparable and meaningful way for companies to better articulate to the financial markets how they create value for their stakeholders and how their strategic resources and capabilities are contributing to the protection and growth of future cash-flows. The goal is to test EY's framework and agree on a set of comparable metrics to measure outcomes for significant areas of value creation, beyond purely financial value, that reflect the execution of a company's strategy and how this links to long term financial value.

The long term value framework

With a focus on outcome metrics to measure the achievement of stakeholder outcomes, the framework considers:

- The context, purpose, strategy and governance behind the outcomes the organisation needs to deliver to its stakeholders
- The stakeholders at the core of the organisation's value creation model and the outcomes the organisation is aiming to deliver to meet those stakeholders' requirements
- The types of value an organisation creates
- The types of risks and threats an organisation manages to protect value
- The strategic assets i.e. the capabilities and resources that are required to deliver stakeholder outcomes



The group is working together over eighteen months of sprints and workshops, to provide those who manage investments with the information to assess long-term value creation, and give investors confidence that their money is working for the long term, not the short-term.

Over the course of the project, asset creators, asset managers and asset owners, together with the Coalition for Inclusive Capitalism and EY, are committed to identifying initial sets of outcome metrics and developing a framework that enables companies to articulate how their strategy will deliver long term value.

The project will collaborate with other initiatives to ensure alignment as far as possible and build on accepted frameworks, standards, methods and leading best practices. At the end of this process, we envision a new set of comparable metrics that will focus on outcomes for each significant area long-term value creation.

While the exact metrics are still up for debate, we are discussing everything from research and development to environmental, social, and governance practices. This includes, workforce engagement, investment in talent and training, customer satisfaction, investment in R&D and innovation, and intellectual property.

At the end of this process, we will have a tested long term value methodology and groups of comparable metrics that will focus on outcomes for each significant area of value. We're talking about specific, investor grade metrics that more fully capture a company's long-term profitability. At the heart of this is the drive towards an open-source methodology which we see as a key factor in establishing a common commitment to change beyond the individual project participants.

A catalyst for change?

To sum up, we believe that:

- Measuring long-term value will become increasingly important in responding to the key drivers of trust, the changing shape of value, the investment disconnect and big data
- Collectively and individually asset creators, managers and owners are becoming more vocal and sophisticated in measuring and communicating long term value, to the financial market and other stakeholders
- The Embankment Project for Inclusive Capitalism, a market-led initiative, can help demonstrate the need for change and start working on the solutions
- The need for consensus on outcome metrics in the investment means that we need to involve the wider business community and other influencers, which we will do in 2018 and beyond

Getting that consensus will not be easy. Different stakeholders value different things so it is going to take discussion, iteration, and hard work to get everyone on the same page.

That is why open sourcing is so important together with a commitment to a change of direction from all parties.

This is about building momentum – like changing the path of a container ship, it might take time but if we can stay focused on the destination, a new perspective on value creation may be in sight.

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