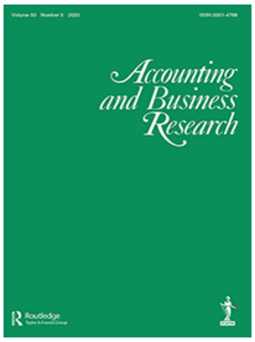

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‘Reporting Matters: the real effects of financial reporting on investing and financing decisions’ - a practitioner view

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Financing and investment decisions occur across a vast range from top corporate executives considering acquisitions of plant, property and other companies, to retail investors running their own portfolio, private equity investors looking to acquire a stake in a business, be that a small first-time buy-out at around a million pounds or Apollo’s recent purchase of the materials division of General Electric for £3.8 billion, up to asset management institutions looking after billions of dollars for their clients.

Across that range there is obviously a wide spread of investor appetite for risk. To get some sense of what that spread might be, I did some research into the investment market, looking at what assets are available to be invested. This information is taken from Wikipedia. It is not particularly current and it is not all from the same year, so it is not directly comparable, but still I think it is relevant for context of what we are talking about.

In 2010 the $32.8 trillion of funds under management came from ultra-high and high net worth private families. Behind that, pension funds, insurance companies and mutual funds provided $31.5, $24.4 and $23.8 trillion of funds respectively. So that is well over $100 trillion from what I would consider to be relatively prudent investors. Obviously, the ultra-high and high net worth families will have a differing appetite for risk but even so, across that cohort I would expect there to be a significant majority in the low to average risk bracket. By contrast, hedge funds and private equity funds represent $2.8 and $2.6 trillion of assets available, so I would suggest this money is more likely to be directed towards higher risk, higher return investments, including value investors down in distressed businesses. Clearly, there is a lot of money out there looking for a home, so how does financial reporting, particularly IFRS, help to define that search? IFRS are mandatory for companies raising equity or debt from publicly quoted markets, so they apply to all PLCs and a number of large private companies accessing the

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public debt markets, or more often these days, large private debt funds which expect their borrowers to use IFRS.

Another statistic is that in 2017 there were 5.7 million limited companies in the UK; 96 per cent of those employed fewer than ten people, so they do not come into the equation. Quoted and large companies made up only 8,000 of that total, less than one-fifth of one per cent. However, these large companies employed 40 per cent of people who work in the UK and generate 48 per cent of turnover. There was no breakdown for profit but I would expect that figure to be higher again. There are not many companies using IFRS, but they are hugely important in terms of generating the recurring income which is so attractive to investors and also to lenders. To illustrate how important this annuity-style income is, look to the rush to invest in Aramco. You will note that two of the top three soundbites for uber-investor Warren Buffett – that is uber as in the best, not Uber as in the company – cash is king and dividends are your friend.

I think this background underpins the points made by Shakespeare (2020). In terms of value, the vast majority of investment is looking for large, stable, well-managed and well-regulated companies, with reliable profits and regular cash flows. It is highly pertinent for the health of the wider economy to understand how financial reporting regulation affects the management of those companies and to aim to improve the ability of investors and management to make an informed choice and then to monitor that investment with confidence. I think the fact that 40 per cent of all employees work in these companies might also explain why their performance correlates with GDP and can also maybe even indicate future revisions.

But I think we need to recognise that this world of large companies, quarterly reporting, oversight and scrutiny is very different to the vast majority of investment and financing decisions taken every day. The large-scale investor uses statistical analysis and big data to support a portfolio approach to investing, ensuring risk is spread so that no single loss is too damaging, and by the law of averages, over the portfolio return they will be within an acceptable range; so, for that community of investors financial reporting almost exclusively informs their analysis. They will have models and programmes to adjust financial reports into a single template in order to make a comparison between different companies, and equally important, for the same company from one year to the next. This is only possible with a transparent, comprehensive and consistent reporting environment. There will be some element of non-financial information, such as broker briefings and press releases, but the insider trading rules are designed to ensure that there should be no competitive advantage from those disclosures. This makes research showing effective changes in reporting on items such as off balance sheet funding vehicles or short-term liquidity swaps, highlighted by Shakespeare (2020), profoundly important, bringing intellectual guidance to bear on thinking for future changes in reporting and disclosure.

This does not mean there will be no errors – again, Shakespeare highlights the problems with CoCos in the early 2000s, and we saw with the 2019 UK general election results how important a real spread of data is for predictive analysis to be truly effective. The regular polls of 1,000 voters projected a much closer outcome than the exit poll, and even the exit poll in Scotland, with fewer data points, was less accurate than the projections for England. In addition, I think there are three areas where reviewing financial reporting based on historical data is potentially at risk of misinterpreting the cause and effect of reporting and disclosure: where decisions are made under exceptional circumstances, where the historical data is based on a different business model to the current business model, and where the data has been manipulated by managers gaming the system.

In 2008 I worked on a review of how the financial products division of a large European bank managed to lose €4 billion. I spoke at length with the team that built the model designed to provide a perfect hedge to corporate risk by tracking the equal and opposite cycles of the diverse industry sectors. This model had been agreed with the auditors as the basis for reporting risk under IFRS, but the model only took its data going back to 2002. It did not include any information from any major financial crisis, and I would think a review of data from the financial crisis that preceded 2002 would show all sectors badly affected by the overwhelming loss of confidence in the market. In terms of business models, I think it would be interesting to see how research into investing in tech companies was impacted by the fact that the speed with which those companies can scale, and equally collapse, was not captured by traditional financial investing metrics. I am interested to see whether financial reporting has been able to adapt, and if so how quickly that adaptation has worked through, to better informed investing decisions in that sector.

Finally, as we heard, poor investment decisions can be the result of the conduct of managers, either empire-building or opting for a quiet life. The conscious decision to manipulate reporting in such a way as to suit their purposes leaves the regulators vulnerable to the managers unpicking any carefully constructed standards, and we know this problem is endemic and is hugely difficult to prevent from the ongoing struggles against tax evasion and from fraud (see, Toms, 2019; Camfferman and Wielhouwer, 2019; Oats and Tuck, 2019). Both (tax evasion and fraud) are examples of managers subverting shareholder interests to their own self-interest. It may be sometimes the root of that self-interest is not greed or criminal intent but actually the shareholders themselves. PitchBook, which is a digital media site for the US private equity industry, recently commented: 'External equity funding creates tremendous pressure. Success is never the end. It is just a sign you will need to be even more successful in the future. You can always work a little bit harder, stay in the office a little bit later, check one more item off the to-do list. Your best is never enough. Sometimes that sense of constant urgency inspires people to do great things. Sometimes it causes them to behave in ways they are probably not too proud of. Sometimes it spurs actions that are downright reprehensible'. That is the view of a US commentator on the US private equity (PE) markets, which is probably the most pro-PE environment in the world. But it is perhaps worth noting at this point that Lehman Brothers, probably the totemic failure and also the first domino of the 2008 global financial crisis, and generally considered to be the victim of vanity empire-building by Richard Fuld, has now actually returned over 100 per cent to its creditors, so it appears the issue was not value but liquidity, and it is not clear that the wider financial community necessarily understood the full implications of this at the time when they declined to support the bank.

Despite these challenges, I would argue that financial reporting is doing the job it is intended to do for these large-scale investors. It will undoubtedly benefit from further ongoing research and deeper understanding of the impact on financing and investing decisions, particularly if the regulators can recognise the fallibility of cold logic to human nature, and are alert to and able to act quickly to close down loopholes before they lead to widespread misstatement. But for lenders or investors working on a particular transaction, while financial reporting is important, not least because the purchaser will want the business to show an improved financial performance in the lead-up to any sale, it is just one of the many factors to consider. As you all know, the accounts are based on historical information and the investment or lending decision is essentially based on what is going to happen in the future of that company, and in isolated cases relying on the trends of previous years as an indicator of future performance is not a sensible way to assess risk. The investor will have a different approach to a lender due to their different ranking in the capital structure. A super senior secured lender will base the vast majority of their diligence on the asset values in the realisation process. The closer the money is to true equity, and therefore most at risk, the more the focus will be on the deliverability of the financial plan, both in terms of commercial drivers and the management's ability to deliver.

Next, I am going to concentrate mainly on the equity investor's approach to analysing the underlying business. Financial Due Diligence (FDD) will be carried out on the recent accounts, usually going back three years, in order to ensure they are accurate in the light of subsequent developments, and look for any discrepancies or inconsistencies. As highlighted by the recent Institute of Chartered Accountants in England and Wales (ICAEW) Corporate Finance Faculty paper on artificial intelligence, FDD is going to become more intensive and comprehensive, but also cheaper and more efficient, with the ability of software programmes to interrogate accounting systems. That development will still require deep financial expertise to interpret the results of the FDD however. The work will also consider the appropriateness of the accounting policies and check those policies have been properly applied, provide evidence of the management's competence in identifying how plans are performing, taking prompt and effective action to promote good practice and quickly shut down unsuccessful initiatives.

As Shakespeare (2020) mentions, with the public accounts of companies going through an IPO or SEO, the investor will pay particular attention to discretionary items, exceptional non-recurring or non-operational costs which are added back to the operating profit or EBITDA figures by management, and the investor will produce their own version of the operating profit for the period under review. If the process timetable allows, investors will want to match monthly management information back to the forward-looking projections in the Investment Memorandum or the sales document, but the more attractive the opportunity, the more the vendor and their advisers will be able to push through a short and light-touch process. As an analogy, in the highly competitive lending market with companies making over 20 million EBITDA, they can usually obtain unsecured lending with very little, if any, covenant oversight. In addition to the FDD, investors will carry out commercial due diligence, speaking to key customers and suppliers, and legal due diligence to assess regulatory and liability risk. Very often, for majority stake investors, particularly where the founder or senior management team are departing post acquisition, there will be third-party assessment of the incoming management, their ability to work as a team, and who the best individual might be to be appointed as chair.

All of this entity-specific due diligence will be overarched by the investment thesis, which will look at the sector and wider economic or demographic factors which may impact on the business over the proposed term of overview. In addition to Artificial Intelligence improving the FDD process, it will be interesting to see how technology impacts on commercial due diligence in certain sectors where it has the ability to analyse data in such a way as to increase the accuracy of projections for consumer-based and impulse-buying decisions. There is compelling evidence to suggest that once sufficient data has been obtained, the algorithms actually know better than the customer what their unconscious preferences and trigger points are. So clearly, to the extent that the underlying data is available to support those predictions, then that will make it easier to see how future trading should look.

In summary, I would say financial reporting is critical to providing guidance to large-scale investors but needs to be constantly evolving to remain effective. It is less critical to making financing and investment decisions on an individual transaction basis but it is definitely still a part of a wider exercise in understanding that business and how it is going to perform.

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