



# the inside track #24

Highlighting CSR Issues of the moment

## Reporting the Business Model

**There has been significant comment and coverage on 'The Business Model' lately. To some it may not mean much and probably for others it perhaps rings a bell regarding past study qualifications; the detailed work required at the time now a forgotten memory.**

However its importance has been heightened following introduction of the FRC's UK Corporate Governance Code, which took effect for listed companies for financial years starting after 29th June 2010. The Code encourages companies to take greater care in describing non financial aspects of their operations in their Annual Report and Accounts (ARA), including a description of the business model.

The Business Model is prominent also, in a consultation by the Department of Business Innovation and Skills (BIS) into "The Future of Narrative Reporting: Consulting on a new reporting framework". This proposes splitting the Annual Report into two parts – a Strategic Report and an Annual Directors' Statement. The Strategic Report aim is to give a more streamlined insight into the ways a company delivers value to shareholders, by including both the business model and strategy. The BIS consultation came fast on the heels of the FRC's report "Effective Company Stewardship – Next Steps"<sup>1</sup>, which further refines the inclusion of the business model within the UK Corporate Governance Code. It recommends risks in narrative reporting focus on strategic and major operational risks inherent in the business model and strategic implementation. In the area of executive remuneration (a favourite BIS topic), the consultation considers transparent disclosure of remuneration in the Strategic Report including performance criteria (the Code recommends appropriate inclusion of non financial metrics as criteria for executives' incentive schemes). The consultation also suggested more reporting on gender diversity (at all levels) and on relevant human rights issues.

The FRC's response to the consultation makes interesting reading<sup>2</sup>. It agrees with the proposal to include information on the business model and strategy, commenting also on the "need to focus risk reporting around the description of the business model and the priorities that flow from that". It goes further by suggesting the Annual Directors' Statement may "become a 'dumping ground' for all sorts of disclosures, with 'boiler plate',

*compliance-driven disclosure*". It also highlights the amount of other initiatives currently in the wings. Nevertheless, it seems that the BIS proposals will translate into legislation, probably for reporting years beginning 1 October 2012.

It is hardly surprising that BIS seeks to proceed quickly. There are pressures on the capitalism model – it's the subject of the Occupy protestors, the Eurozone crisis, the call for more transparency, greater stewardship by investors, the ability to borrow money and so on.

Equally there have been business failures due to inadequate business models. Southern Cross is perhaps a good illustration where failure was certainly in part due to a potentially brittle business model. The homes had landlords, who wanted to leave the Group when funding difficulties arose and they were not paid. The 2010 Annual Report gave no clear business model, showing they clearly relied on landlords for premises and when revenues fell (largely for external reasons), the business would have nowhere to go. Investors were caught out (as well as clients) because there was little business model transparency. If clearly stated, maybe the risks would have been apparent and early action taken. Similarly Northern Rock's business model predicated regular rolling over of funding (this came to light after its demise, and the business model was heavily criticised in hindsight).

Of course, the challenge for companies is to fully understand what is a "business model"?

<sup>1</sup> The Financial Reporting Council's detailed recommendations can be found at [www.frc.org.uk/about/effcompsteward.cfm](http://www.frc.org.uk/about/effcompsteward.cfm)

<sup>2</sup> The FRC's response can be found on its website - [www.frc.org.uk/publications/pub2679.html](http://www.frc.org.uk/publications/pub2679.html)

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So what is a business model - the UK Corporate Governance Code offers no guidance. Google is a reliable standby but inserting "Business model" offers 141m results (in 0.13 minutes!) – probably far too many to look through to gain a suitable understanding!

In TVC's research on reporting by a sample of UK listed companies considered as potential "early adopters" of the UK Corporate Governance Code<sup>3</sup>, we offered two very simple definitions –

*"How a company makes and spends money TODAY" – or – "How a company creates value for its shareholders".*

Their strength is simplicity but are they sufficient and fit for purpose given the complexities impinging on a business today? For the research, business model descriptions were evaluated on whether the description commented on the current means of revenue generation, the company's key markets, areas of competitive advantage and pricing/costing strategies.

Our view was based on what is practical and helpful to enable companies to report comprehensively. A lot of time can be wasted on a precise definition for a 'fit for purpose' business model. It needs to describe the operations of a business including the funding, the business functions, and the value, revenues and expenses that the business generates over time.

In our work with clients, we see many examples of business models, some particularly good, such as Aggreko and ARM, and others so simple that they convey no insight to shareholders and investors.

Our experience suggests to develop a company's business model requires a comprehensive understanding of the key activities that drive the company. Once established, it is easier to develop the business model and identify non financial metrics that are true Key Performance Indicators. In a recent ICSA Round Table on narrative reporting<sup>4</sup> in which we participated, the Group Company Secretary of Halfords commented on the benefits of spending time in considering the business model: *"Using a business model allowed us at Halfords to focus on what we thought the business was. That then fed what we said on risk and how we reported it."*

Such an approach helps companies meet the requirements proposed under the BIS consultation, which also referred to CSR information. The Strategic Report will include comment on key (or material) environmental and social performance, whilst the Annual Directors' statement will be

the receptacle for other CSR related information. Identifying key business drivers enables companies to identify specific CSR activities material to driving value, for inclusion within the Strategic Report. Possibly, only two or three CSR activities are material – and it is probable that these relate to employees and customers. That does not mean other CSR elements are irrelevant to the business model. Their impact may be longer term, particularly on a company's reputation.

In the context of longer term performance, it is worth noting a recent Harvard Business School Working Paper – *"The Impact of a Corporate Culture of Sustainability on Corporate Behavior and Performance"*<sup>5</sup>. This investigated the effect of a corporate culture of sustainability on multiple facets of corporate behaviour and performance outcomes. Using Dow Jones Sustainability data, considering performance of a sample of 180 companies over 20 years, it provides evidence that, what the authors term, "High Sustainability Companies" significantly outperform counterparts over the long-term, both in stock market and accounting performance.

This study highlights it is less about how companies report performance and more about whether they *"walk the talk"*. Moving to a Strategic Report, focusing on the business model and achieving a better understanding of the key business drivers enables companies to become better at *"walking the talk"*.

<sup>3</sup> TVC's research is on its website [www.thevirtuouscircle.co.uk/REPORTS/Narrative-report-research.doc](http://www.thevirtuouscircle.co.uk/REPORTS/Narrative-report-research.doc)

<sup>4</sup> ICSA Roundtable – issued as a supplement to Chartered Secretary magazine – October 2011

<sup>5</sup> The Harvard Business school Working Paper written by Robert Eccles, Ioannis Ioannou and George Serafeim can be found at <http://www.hbs.edu/research/pdf/12-035.pdf>

**If you are facing challenges in developing your business model, the key business drivers or the non financial metrics, and would like an objective and impartial view on your approach, contact Tony Hoskins - [thoskins@thevirtuouscircle.co.uk](mailto:thoskins@thevirtuouscircle.co.uk) or Ian Redington - [iredington@thevirtuouscircle.co.uk](mailto:iredington@thevirtuouscircle.co.uk)**