



## Investors and corporates - the way ahead



Interview with Ken Lever, Finance Director, Tomkins plc

### **Pressures faced by finance directors**

Q.

**What increased pressures are finance directors under these days with moves towards tougher accounting controls and greater disclosure?**

A.

I think the trend towards additional work and time being spent in this area is something that has been going on for some time. If you look back over, say 20 years, and think about the size of an annual report 20 years ago and compare them today, it is a very different document. But the recent developments which I think have added significantly (probably to the onus of the finance function rather than necessarily just the finance director) are things associated with corporate governance and regulation and the increase in complexity of accounting.

If you take the increase in complexity of accounting first of all... a lot of people are critical of the historic cost accounting and the traditional reporting model and I am actually known as being a slight critic of it myself. I don't actually think that that is the problem in itself. I think the issue that has arisen is that an increasing number of accounting standards (things such as financial derivatives, pension fund accounting, those sorts of complex accounting standards which are now around) are just adding to the difficulty of understanding the information that is presented and also adding to the difficulty of collating, summarising and reporting that information. So the real issue on that is actually just complexity and whether that complexity is really going to add value to the business.

But on the issue of corporate governance, we have had Turnbull for some time, of course, but now we've got Sarbanes-Oxley in the US. And so for US registrants clearly there is a big focus on the information that is now required and the internal controls that are now required to actually comply with the regulations that are being introduced in the US. Those two things together are leading to businesses having to employ more people so that they can actually produce all of this information. I guess, ultimately, the test at the end of day is whether it is actually going to add value to the business. So yes it does actually add to the burden. I think it is a growing burden and it is one which unfortunately now seems to be a feature of a public company life.

### **Too much information for investors?**

Q.

**Do you think that investors can be given too much information?**

A.

I think it depends actually on the type of information, what the information could be used for. I think the key thing for an investor is actually that he gets information that is going to help him with the decision that he needs to make. If it's a potential investor, does he want to invest in the company? Or if it is an existing investor, does he want to retain or increase his investment in the company? I think a lot of the information that investors currently have doesn't necessarily address that particular issue. What I mean by that is that the traditional reporting model focuses very much on historic cost accounting (nothing wrong in that in itself) but there is a need for information that helps the investor better understand how a business creates value. And so, in my view, what is actually needed is another reporting

## IN THE NEWS

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framework that can co-exist with the traditional accounting framework which focuses on value creation, how business goes about creating value.

One of the issues to me on that is that the existing accounting standard-setters seem to be going down the track of converting the historic cost accounting model into a fair value type model which actually is trying to make it into something which it really wasn't intended to be. It's a normal thing. It is something that is trying to address a number of purposes at the same time and I am not sure that that model is necessarily attainable.

### The City and corporate Britain

Q.

**So much shareholder value has been destroyed in recent bear market conditions, do you think the City could try and work more constructively with corporate Britain?**

A.

It's an interesting one because I think this subject of whether shareholder value has been destroyed or not is up for debate because it depends how you look at shareholder value. I would argue what has actually happened in this bear market is that the market has corrected values (or the perceived values based on the market) back into what really is essentially the inherent or intrinsic values of the businesses. Because shareholder value is something people tend to misunderstand. They tend to think it is the number of shares in issue multiplied by the price of the share. But, in actual fact, what shareholder value is about is an economic concept. It is all about the ability for a company to generate a growing and sustainable cashflow into the future. And that is really based on the competitive position of the company and the attractiveness of the markets it is actually operating in.

So I think the issue is not so much that the bear market has necessarily destroyed value. It is more to do with the correction of value. Now it may well be that it has actually over-compensated and for some companies there has been a bigger over-compensation than others. Where I think the City could actually work to constructively help in that process is to understand better how businesses go about creating value and actually look more to the sort of medium and long-term investment in businesses, rather than just a short-term process. Because creating value is not a linear process, it actually takes time over the medium and long-term rather than taking place in the short-term.

### The long-term investment view

Q.

**Obviously you would like investors to take the long-term view, doesn't this mean managing expectations about the likely returns from equities more realistically?**

A.

You have to, in a way, define what you mean by returns on equities. I think most people would accept that really the return on equities is essentially a function of risk-free rate and the equity risk premium. And in the 1990s what tended to happen was that when we saw the upward and onward march of the stock markets it seemed to be as though anything you put money in, actually you could get additional value out of. And, of course, that led to the risk premium being seen as something that was actually very small. But, in reality, the returns that you get from equities can only be a function of this risk-free rate, the risk premium itself, and essentially, over time, it is to do with dividends that you can earn on the investment and also to do with growth. Of course growth is actually a function of GDP growth. So what was happening in the 90s was that the expectations on returns just got out of kilter with reality. So I think the sophisticated investor really does understand, long-term, that returns realistically can't be higher than, say, 8 or 9 per cent.

### Investment and company's planning

Q.

**Does the failure of investors to think long-term really prevent companies planning long term?**

A.

Again it is a very interesting question. I think that people argue that there is no real evidence to say that investors don't actually think long-term. I think in some respects I

## IN THE NEWS

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would agree with that but I think in a way it is partly to do with the focus on the wrong metric. There is a lot of focus still (particularly in the United States and perhaps less so in the UK) on the earnings per share metric. And, of course, earnings per share isn't really a value metric as such. It is actually an accounting metric and it is something which does get managed in the short-term and a number of people have talked about the 'earnings game'. I think the issue on earnings is really that if you try to use that in terms of how a business creates value over the long-term, it won't necessarily give you the right answer. I think a good example is if you are a company that has to make, say, rationalisation decisions in its manufacturing facilities, then clearly there is a significant cost attached to that. Now, if there is a focus all the time on earnings per share, then what will happen is a company won't necessarily make that decision because it will have a hit on earnings. Now, if that same company was in a private equity environment, where it didn't have the public company spotlight and public company exposure, then it could take a different view. It could still do that because its focus is actually on long-term, sustainable cashflow and creation of value in the longer term, and it doesn't worry unduly about the earnings per share metric.

### Shareholder activism

Q.

**The inquiry team you are now involved in has talked about making companies more accountable to their owners. Does this mean you embrace increase in shareholder activism?**

A.

I think you have to recognise that, at the end of the day, the shareholders are the owners of the business and I think, generally speaking, it is to be encouraged that the shareholders do show an interest in the business. I think one of things which is always surprising to me is that when you have an annual general meeting for instance, you get relatively few major shareholders who would come along to that meeting. I think it is important that there is a constructive dialogue between the shareholders and the management. And, at the end of the day, if a shareholder is unhappy with his investment he has got choices and he can, if he likes, sell the shares and just leave it for somebody else. Or he can actually try and influence change in the business by making a management change. So if a shareholder is unhappy that the managers aren't actually creating value, then it is important that they do have some input into that process. However, I think it does focus again on this issue about allowing management to have the time to create value (because it does take a period of time) and not to react too quickly to short-term metrics.

**Tomkins has leant its support to the inquiry launched by [Tomorrow's Company](#) in to how business should conduct itself in the 21st Century. The issues being considered are how the investment system can make a more meaningful contribution to long term wealth creation, the way in which companies are caught between creating shareholder value and yet expected to respond to wider social concerns and the need for a greater dialogue between business, government and civil society. In this context, Ken Lever looks at the changing role of finance directors, how investors and corporates interact and the rising tide of shareholder activism.**

- **Ken Lever, Chief Financial Officer of Tomkins is the representative of Tomkins on the Twenty First Century Investment Inquiry Team of Tomorrow's Company. The Inquiry is looking into the workings of the investment model in the UK. Tomkins is supporting the Inquiry Team initiative by representing the company perspective in the workings of the investment model.**