Communicating and reporting on the business model

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1. INTRODUCTION

The problem – as well as the prospect – with business models is that they are concerned with being different; as business in general thrives on some sort of unique selling point. So the bundle of indicators on value creation, business models, strategy, intellectual capital, and so on, which will be relevant to analyze or communicate about will differ from firm to firm.

Therefore, this paper focuses on the business model as the integrating concept for reporting and analysis of strategic types of information on e.g. management strategies, critical success factors, risk factors and value drivers. Disclosure of information on these aspects, has in recent years gained importance, and several reports (Blair & Wallman 2001, Eustace 2001, Upton 2001, Zambon 2003, WBCSD 2003) and researchers (Lev 2001; Beattie & Pratt 2002) have argued that the demand for external communication of new types of value drivers is increasing as companies increasingly base their competitive strengths and thus the value of the company on know-how, patents, skilled employees and other intangibles.

Actually, the supply of information on the value creating processes and value drivers in companies is also increasing in various reporting media such as annual reports, IPO prospectuses (Bukh et al. 2005) and analyst reports. However, some firms, especially in the Nordic countries, have started developing Intellectual Capital (IC) reports that communicate how knowledge resources are managed in the firms within a strategic framework, and new models for reporting on stakeholder value creation and Corporate Social Responsibility (CSR) are emerging and gaining momentum even in finance circles.

Most literature on new reporting models and disclosure in general suggests that key value drivers that are strategically important should form the basis for the disclosure of information and therefore also the dialogue with the investment community, like e.g. financial analysts institutional investors, venture capitalists and news media. Traditionally, a major part of the fundamental analysis and financial analysis of a firm is a comparison with the performance of other firms and similar key ratios or non-financial information from firms in the so-called peer-group. This is, for example, typically used when financial ratios are computed and compared across firms, or when specific value drivers within an industry as when Revenue Passenger Miles, Available Seat Kilometres and Passenger Load factors are compared within the airlines industry or Combined-ratios are compared within the insurance industry.

Strategy, on the other hand, at least competitive strategy in Porter’s sense, “is about being different”, which means “deliberately choosing a different set of activities to deliver a unique mix of value” (Porter 1996). Thus, the bundle of indicators or value drivers that would be relevant for disclosure are likely to differ among firms, and they can be expected to be difficult for analysts and investors to interpret, unless they are inserted in the strategic context that determined their relevance.

A business model is concerned with the value proposition of the company, but it is not the value proposition alone as it in itself is supported by a number of parameters and characteristics. The question is here: how is the strategy and value proposition of the company balanced?? Conceptualizing the business model is therefore concerned with identifying this platform, while analyzing it is concerned with gaining an understanding of precisely which levers of control are apt to deliver the value proposition of the company. Finally, communicating the business model is concerned with identifying the most important performance measures, both absolute and relative measures, and relating them to the overall value creation story.

The point of departure for some suggestions in relation to voluntary reporting and management commentary is to illustrate the flows of value creation by linking indicators to strategy and supporting an understanding of them by providing a context giving narrative (Nielsen et al. 2009). Mouritsen & Larsen (2005) label this a process of “entangling” the indicators, arguing that individual pieces of information and measurements by themselves can be difficult to relate to any conception of value creation. As such, this “flow” approach is
concerned with identifying which knowledge resources drive value creation instead of assigning a specific dollar value to those resources (Bukh 2002).

2. THE DEMAND AND SUPPLY OF VALUE-CREATION INFORMATION

The developments of the so-called Business Reporting models are closely connected with the need for greater amounts of information than companies are obliged by law to disclose in their financial statements. Furthermore, recent research shows a rising dissatisfaction with the current reporting and disclosure levels of companies. Sullivan & Sullivan has e.g. stated that the shift in the nature of value creation makes the valuing of knowledge-based companies difficult, because “[t]raditional accounting methods [...] are inadequate for valuing companies whose assets are largely intangible” (2000, 328). Furthermore, both academics, standard setters and professionals alike, express the need for more comprehensive business reporting. There are numerous reasons for this, including aspects such as better compliance between company management and capital market agents’ disclosure perceptions, which can also be termed as a need for a greater focus on user needs, ultimately leading to more accurate valuation and thus a more efficient capital market.

In 2001, Robert Verrecchia conducted an extensive review of research in the disclosure field, dividing the existing research into the three groups: association-based, discretionary-based and efficiency-based disclosure literature. Despite the fact that Verrecchia’s point of departure is the examination only of quantitative disclosure models, the field of business reporting with more qualitative oriented reporting models, can be associated with the area of discretionary-based disclosure, which Verrecchia describes in the terms: “The distinguishing feature of work in this category is that it treats disclosure as endogenous by considering managers’ and/or incentives of firms to disclose information known to them; typically this is done in the context of a capital market setting in which the market is characterized as (simply) a single, representative consumer of disclosed information” (Verrecchia 2001, 99).

Business reporting being an expansion of the normal and regulated disclosures of the companies can be viewed as a public information channel. The need for additional reporting is seen as a result of the need for greater focus on user needs (AICPA 1994, Jonas & Young 1998). In the light of this, the focus on the development of reporting practices can be connected with the fact that investors are more interested in raw accounting data rather than processed data obtained through for example analysts (Barker 1998).

The results from Vivien Beattie’s (1999) report, “Business reporting: The inevitable change”, indicated already in 1999 an increasing attention towards non-financial information, even though this information still is weighed lower among analysts, investors and banks than traditional financial information. In general, companies, investors and analysts are becoming more aware of information about factors that are not reflected in the financial statements, although traditional financial information still is considered most important. In return, the respondents seem to be demanding more information about risk factors and reliable information about the management’s qualities, expertise, experiences and integrity. This is evident in many recent Corporate Governance codes of conduct worldwide and in can be seen to some extent as a reaction to the financial crisis beginning in 2008. This kind of information is seen as a relevant and critical success factor for the ability of an organization to create value. This could be interpreted as a need for the type of information contained in intellectual capital statements and other new reporting models.

Various studies of investors and analysts’ request for information indicate a substantial difference between the type of information found in the annual company reports and the type of information demanded by the capital market (Eccles et al. 2001; Eccles & Mavrinac 1995, Beattie & Pratt 2001). As the nature of value creation has changed from physical buildings and plants and equipment to patents, skilled employees and strategic relationships, directing more attention towards the relevance of disclosing information regarding the knowledge resources of a company. This information gap could therefore be due to an increased request for more non-financial information, i.e. compa-
ny strategy and competencies, the ability to motivate staff, increase customer satisfaction etc.

There seems to be evidence suggesting that the stated information gap in effect finds its origins in a lack of understanding and proper communication between company management and the capital market and also that the capital market actually does value long-term strategic planning. This indicates that we might need to turn our focus on establishing a common understanding between company management and the capital market participants on the strategic intent of the company in order to solve this understanding gap. Maybe the answer to this lies in creating a common understanding of performance value drivers by reporting on the value creation process through a mutual business model understanding.

In the light of the tech-stock crash of 2000, it became evident that merely operating with a certain business model no longer is enough to please investors. Henceforth, profit generation was also required. Many efforts to support sufficient reporting on the value creation processes and business models of companies have been made. Examples of such business reporting models are: Value Reporting (Eccles et al. 2001), The Value Chain Scoreboard (Lev 2001), and the Intangibles Asset Monitor (Sveiby 1997).

In relation to the effect of non-accounting information on investment decisions, an experiment carried out by Catasus & Gröjer (2003) concludes that the possibility of creating reliable data about intangibles makes accounting for intangibles meaningful for credit decisions, and Solomon et al. (2000) illustrate that increased risk reporting is in the interest of the capital market, because it is helpful to portfolio investment decisions. Other studies conducted by Previts et al. (1994) and Galbraith & Merrill (2001) show that information on strategy and management experience is also incorporated into investment decisions, although it is important to take a critical stance towards non-accounting disclosure by questioning the reliability of voluntary information disclosed by managers.

From a likewise critical perspective, there are also signs pointing in the opposite direction, i.e. that the capital market is still not interested in non-accounting information. Johanson (2003) finds that capital market actors seem to be ambivalent towards information about certain indicators on intellectual capital, while other authors suggest that this may be because of the capital market agents’ inability to understand how such factors affect value creation, including their own value creation chain (Holland & Johanson 2003), or that their inability to incorporate such types of soft information lies in the cultural aspects of the capital markets.

Still, the main opposing stance can be summarized in the words of Fenigstein (2003): “The value of any business stems from its ability to generate cash.” It could very well be a problem that the capital market agents simply do not understand non-accounting information sufficiently. García-Ayuso suggests that companies too are responsible for such a lack of comprehension and states that “managers must use a language that financial analysts and investors are able to understand. They have to provide explanations of the value creation process in the firm and make clear links between intangible investments and future value creation” (2003, 64).

3. THE BUSINESS MODEL AND BUSINESS REPORTING

The point of departure for many of the recent developments in voluntary reporting, especially the so-called narrative models, is to illustrate the flows of value creation by linking indicators to strategy and supporting an understanding of them by providing a context giving narrative (Nielsen, Roslender & Bukh 2009). Mouritsen and Larsen (2005) label this a process of “entangling” the indicators, arguing that individual pieces of information and measurements by themselves can be difficult to relate to any conception of value creation. As such, this “flow” approach is concerned with identifying which knowledge resources drive value creation instead of assigning a specific dollar value to those resources.
Hägglund (2001) and Mouritsen et al. (2001) accentuate that the understanding of the value creation of the firm would be facilitated if companies disclosed their value drivers as an integral part of the strategy disclosure in the management review. Further, this communication would be even more effective if the framework for disclosure was based on a common understanding of the value drivers of the company (Bukh & Johanson 2003, Osterwalder 2004). Along these lines the business model may possibly enable the creation of a comprehensive and more correct set of non-financial value drivers of the company, thereby constituting a useful reference model for disclosure.

The problem with trying to visualize the company “business model” is that it very quickly becomes a generic organization diagram illustrating the process of transforming inputs to outputs in a chain-like fashion. The reader is thus more often than not left wondering where the focus is in the organization, and key differentiating aspects of the business model are drowned in attempts to illustrate the whole business. This is why the communicative aspects are so important.

From a narrative perspective, business models can be a support mechanism for projection of the management view to the organization through e.g. storytelling. The organizational narrative is also a kind of abbreviation supporting the ability of remote control, in essence constituting a representation of the business through a description; i.e. a story of how it works (Magretta 2002) and the relationships in which it is engaged. A business model can therefore be thought of as a comprehensive description of the business system, including how the experiences of creating and delivering value may evolve along with the changing needs and preferences of customers. Such a narrative is an explanation of how the organization intends to implement its value proposition, much like the function of the knowledge narrative of an intellectual capital statement.

The business model may potentially constitute a platform for the supplementary reporting of the company, for example, concerning strategy, value creation processes, knowledge resources etc. Generally seen, it is about communicating the company strategy, critical success factors, degree of risk, market conditions etc. in such a way that the investors realistically can assess how the company is actually doing and which expectations they may have to the future development. In practice, it has proven fairly difficult to do this in a way which is not too comprehensive and complicated, and which does not in an inappropriate way go too close to information which cannot be published, e.g. for the sake of legal requirements, partners or competitive conditions.

Internationally, several committees, commissions and groups of experts have during the past ten years worked on the development of guidelines and recommendations. For example, Blair & Wallman (2001, 59) have argued that the supplemental reporting from the company should reflect the dynamics, which drive the value creation in the company. The communication and reporting from the company should ultimately constitute a representation of the company business model “by describing the relationships among the various input measures and outcome measures, and to link the primary inputs to intermediate inputs and, ultimately, to financial performance and other measures of total value creation” (Blair & Wallman 2001, 43).

In relation to the communication and Investor Relations work done in large publically traded companies, the business model may thus be perceived as a model which helps the company management to communicate and share their understanding of the business logic of the company with external stakeholders. This is often described as “equity story” in finance circles. These stakeholders do not only comprise analysts and investors, but also partners, the society and potential employees. This business model-bound equity story is related to the business-oriented tendencies within corporate branding. The main point here is that corporate branding is about rendering visible the interaction between the company strategy, internal company culture and image. Thus, corporate branding is an interconnected practice for the whole organization and not only an expression of the marketing department perspective. In this way, the notion branding becomes a question of explaining how the company earns money rather than an explanation of responsibility towards internal and external stakeholders.
The idea of equity story communication is thus that the uniqueness of the value creation in the company is taken as the starting point in relation to external parties. Sandberg (2002) formulates this in the following way: “Spell out how your business is different from all the others.” Osterwalder & Pigneur (2003) consider the process which the management is going through in connection with a modelling of the company as an important tool to identify and understand central elements and relations in the business, for example value drivers and other causal relations.

Together with consistency, a firm structure for the communication of information and the very information may help the external stakeholders in the company to understand how new events affect its future prospects. In this way, the company can minimise the spread in the analysts’ estimates which affect the uncertainty about the “real” price determination which, as discussed above, affects the capital costs.

4. GOOD ADVICE ON COMMUNICATING BUSINESS MODELS

The problem with trying to visualize the company “business model” is that it very quickly becomes an illustration of the processes of transforming inputs to outputs in a value chain-like fashion. The reader is thus more often than not left wondering where the focus is in the organization, and key differentiating aspects of the business model are drowned in attempts to illustrate the whole business. This is why the communicative aspects of focusing the information are so important (Nielsen & Madsen 2009).

At the very core of the business model description should be the connections between the different elements into which we traditionally divide the management review. Companies often report a lot of information about e.g. customer relations, employee competencies, knowledge sharing, innovation and risks, but this information may seem unimportant if the company fails to show how the various elements of the value creation interrelate and which changes we should keep an eye on.

It is crucial for the readers’ understanding of the business model that the company presents a coherent picture of the value creation in the company; e.g. by providing an insight into the interrelations that induce value creation in the company. Moreover, the non-financial reporting should follow up on the strategy plans and development in the business model in order to ensure consistency over time. As a business model should not necessarily be understood as a value chain, it should therefore not necessarily be reported as one.

A business model is also a forward-looking statement, which goes beyond an identification of the immediate cash flows of the company. In capital market language, one would say: It is a statement on how the company will survive longer than till the end of the budget period. This means that when describing one’s business model, it is not enough to talk about the historic development of the company, not even if it includes an account of the company historic value creation, the company concept and how the objectives and strategy have turned out in the company.

Another central tool when describing company history is to support facts by non-financial performance measures. One thing is to state that one’s business model is based on mobilizing customer feedback in the innovation process, another thing is to explain by what means this will be done, and even more demanding is proving the effort by indicating: 1) how many resources the company devotes to this effort; 2) how active the company is in this matter, and whether it stays as focused on the matter as initially announced; and 3) whether the effort has had any effect, e.g. on customer satisfaction, innovation output etc. According to Bray (2010, 6) “relevant KPI’s measure progress towards the desired strategic outcomes and the performance of the business model. They comprise a balance of financial and non-financial measures across the whole business model. Accordingly, business reporting integrates strategic, financial and non-financial information, is focused on future performance, delivered in real time, and is fit for purpose”.

One of the keys to making management commentary matter to the investment community is therefore to emphasize the interconnection between parts of the narrative sections according to the logic of the busi-
ness model. The next section looks at the differences in focus on the information types that relate to the business model between management commentary and fundamental analysis research.

We need to identify the most important performance measures that relate to the overall value creation story. We want to illustrate the flows of value creation by linking indicators to strategy and by providing a context-giving narrative. Mouritsen & Larsen (2005) call this a process of “entangling” the indicators [although we might call it interlinking and integrating], arguing that individual pieces of information and measurements by themselves can be difficult to relate to any conception of value creation. So we are concerned with identifying the knowledge resources that drive value creation – rather than assigning a monetary value to them.

About the authors

Christian Nielsen is Professor at Aalborg University, Denmark and Visiting Professor at Macquarie University, Australia. Christian heads the Business Model Design Centre (www.bmdc.aau.dk), one of the world’s leading interdisciplinary centres of excellence in business model research. Christian has worked with the field of analysing and valuing business models since 2001 both as a researcher and as a buy-side analyst, portfolio manager, consultant and board member and is also Joint-Editor of the Journal of Business Models.

Morten Lund, Assistant Professor at Aalborg University, Denmark and the Business Model Design Centre, was Lab manager at the International Centre for Innovation for 5 years and has led a USD 11.0 mio. project to develop 10 international network-based business models. His PhD dissertation from 2014 focused on the DNA of successful business models and how to innovate them using narratives.

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