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1. PROVIDING INFORMATION BEYOND GAAP

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Baruch Lev has documented that in 1970s and early 1980s reported earnings and book values explained a whopping 75 percent to 85 percent of the differences in capitalisation across companies in the U.S., but the same information accounted for barely 30 percent to 40 percent of the differences in capitalisation in recent years.

What does this mean? It means that GAAP-based statutory financial reports no longer are adequate to fulfill the information needs of investors. To avoid mispricing of shares and excessive price volatility, companies must provide a substantial amount of high quality information not currently mandated by GAAP. Indeed, many companies do that. For example, pharmaceutical companies give details of product pipeline, Internet companies provide information on the number of eyeball visits, retailers disclose same-store sales data, and so on. Yet, most companies do it somewhat haphazardly and ineffectively.

There seems to be a compelling case for reducing informational asymmetry—a ubiquitous phenomenon, informational asymmetry means that one party to a contract or trade has more information than the other party—between management and investors. Why? Research suggests that surprisingly large informational asymmetry hurts more the informationally-advantaged. How can that be? George Akerlof, a Nobel Laureate in Economics, offers an explanation using the example of used cars.

As we know, in the market for used cars (“pre-owned “cars in modern jargon), there are good and bad cars. Sellers as owners of these cars obviously can distinguish between good cars and bad cars, but buyers may not know if there are no reliable facilities to check cars and no legally valid declarations given by the sellers. This is clearly a case of informational asymmetry. In such a market, Akerlof said, “good cars and bad cars must sell at the same price, since it is impossible for a buyer to tell the difference.” This uniform price will be relatively low because buyers being vulnerable will assume that all used cars offered for sale are ‘lemons.’ What will this mean? Sellers of good cars will not participate in such a market—the better the car, the stronger the incentive of the seller to withdraw from the market. Thanks to informational asymmetries, the market for used cars will degrade to a “lemons “market. Who loses when that happens? Almost everybody. Owners of good cars cannot sell their cars at the right price and buyers are denied an opportunity to buy good cars.

A profound lesson, the lemons model applies to all situations where informational asymmetry exists. In the corporate world, too, informational asymmetry leads to deleterious consequences, argues Baruch Lev. According to him, the chain of causation is as follows:

Informational asymmetry
↓
Information risk premium
↓
Excessive cost of capital
↓
Deleterious consequences

Reasons for Increase in Informational Asymmetry

Why has the informational asymmetry increased over time? The primary reason is the dramatic increase in the importance of intangible assets and the logic-defying GAAP treatment of intangibles. According to GAAP, intangibles acquired in M&As or other transactions are capitalised, but the cost of internally generated intangible assets (patents, brand name, improved business processes, and so on) are immediately expensed. Such treatment detracts from the informativeness of corporate financial reports. As the CEOs of the world's six largest accounting firms stated forcefully, "The large discrepancies between the 'book' and 'market' values of many, if not most, public companies ... provide strong evidence of the limited usefulness of statements of assets and liabilities … Clearly, a range of 'intangibles' that are not well measured, or not measured at all, under current accounting conventions are driving company performance. Investors and other stakeholders…. want to know what those intangibles are and how they might plausibly affect how businesses perform in the future."

Some Suggestions to Improve the Informativeness of Financial Reports

Baruch Lev, an internationally acknowledged expert on investor communications, offers the following suggestions in his authoritative work *Winning Investors Over*[1]:

• Resurrect and improve pro forma earnings

• Present the path-to-growth report

Pro Forma Earnings Pro forma earnings represent management attempt to improve on GAAP income. It represents management's attempts to improve on the deficiencies of GAAP earnings by releasing its own alternative number along with GAAP earnings. SEC requires that non-GAAP measures, such as pro forma earnings, should be reconciled quantitatively with the relevant GAAP numbers.

Research suggests the usefulness of proforma numbers. Pro forma earnings seem to be more strongly associated with stock returns than GAAP earnings.

The Path-to-Growth Report The path-to-growth report is a template that articulates the business model of the firm, which is what investors in essence want to know. The template for the path-to-growth focuses on inputs or investments, followed by intermediate outputs, and finally, the ultimate outputs.

[1]. Published by Harvard Business Press, 2012.

The following examples, provided by Baruch, Lev illustrate these distinctions.

Inputs (value drivers)		*Intermediate outputs*		*Ultimate outputs*
Innovation: R&D and acquired technology	→	Patents, trademarks, product pipeline	→	Innovation revenues; cost savings
Customers: Brand creation and enhancement	→	Trademarks and brand values, customers' loyalty and lifetime value	→	Market share; price

Baruch Lev provides a generalised template for path-to-growth disclosure, which includes, in addition to the above inputs (value drivers), the following five.

- Human capital
- Connectivity
- Internet actions
- Organisation capital
- Risk management.

2. THE WISDOM OF CROWDS

Dr. Prasanna Chandra

In his book *The Wisdom of Crowds,* James Surowiecki argues that the aggregation of information in groups results in decisions that are often better than what could have been made by any single person in the group. Michael Mauboussin gives an interesting example of this phenomenon. He passed a jar containing 1116 jellybeans to 73 students asking them to guess the number of jellybeans in the jar. The consensus estimate (the average of all the individual estimates) was 1151 (off by about 3 percent). Importantly, only 2 out of 73 students fared better than the consensus.

In his book *The Difference* Scott Page addresses the "why" of the wisdom of crowds. One of his core ideas is the "diversity prediction theorem." According to this theorem

Collective error = Individual error (the ability of the individual)

– Diversity of prediction (cognitive diversity).

The diversity prediction theorem has the following implications:

1. The collective is always smarter than the average person within the collective.
2. Diversity contributes significantly to collective accuracy.

3. Often the collective may be better than even the best of the individuals.

The following conditions have to be satisfied for the expression of wisdom of crowd:

- There must be *cognitive diversity* in terms of perspectives, rules of thumb, interpretation, and so on.
- There has to be an aggregation mechanism- the most familiar *aggregation mechanisms* are financial markets.
- Incentives must exist in the form of rewards for being right and penalties for being wrong. The most common incentives are monetary incentives.

3. TECH MAHINDRA

Dr. Prasanna Chandra

In January 2009, Ramalinga Raju, Satyam Computer Services' chairman, admitted to accounting manipulation at what then was regarded as one of India's IT success stories. He confessed that over $1 billion of cash and bank balances stated as assets on the company's books did not exist. In the wake of this scam, Satyam lost 23 clients and revenues shrank from $1.6 billion to $990 million.

In April 2009, Tech Mahindra agreed to buy a 31% stake in the scandal- ridden Satyam Computers for 58 per share. The stake went up to 43% after the mandatory open offer. At that time, Tech Mahindra's revenues were around $1.15 billion. Even before the scandal broke out, Tech Mahindra had evinced interest in Satyam Computers but Ramalinga Raju, understandably, evinced little interest.

Immediately after the acquisition the senior management team, which moved from Tech Mahindra to Mahindra Satyam, initiated steps to revive the company back to health and restore confidence. Executive vice- chairman Vineet Nayyar and managing director C.P. Gurnani spen't the following year on the road, meeting clients to reassure them about business continuity.

The top and senior management spent considerable time reassuring the clients about business continuity, communicating with employees through various channels about the developments in the company on a daily basis, improving the anaemic margins and operating efficiencies by shedding excess infrastructure and rightsizing the organisation.

Four years after the takeover, Mahindra Satyam was merged with Tech Mahindra in 2013, with Tech Mahindra giving two shares for seventeen shares of Mahindra Satyam.

In order to bolster is presence in key verticals, Tech Mahindra made the following acquisitions beginning from March 2012 through April 2014.

DATE	COMPANY	SEGMENT	CR
Apr'14	FixStream Networks	Big data	60
Apr'14	Assets of Sony's Testing Labs	Software Testing	-
Nov '13	Mahindra Engineering Services	Engineering	720
Feb '13	Complex IT	Sap consulting	NA
Sep '12	ComViva*	Mobile VAS solutions	260
Sep '12	Hutchison Global Services	BPO	480
Mar '12	Customer	BPO	140

Thanks to its successful turnaround and other acquisitions which have worked out well, Tech Mahindra has performed admirably. During the five year period 2009-2014, revenues and profits have grown at a CAGR of 33% and 24% respectively. Its string of acquisitions have helped it in augmenting service offerings, diminished its dependence on the telecom vertical, and diversified its geographical base. Buoyed by its success, the company set an ambitious target of $5 billion in revenue by 2015. The company has emerged as a formidable alternative to tier 1 players in the industry.

Lauding Tech Mahindra's performance Ashok Soota, an industry veteran, said "I think they have done a rather remarkable job with Satyam because acquisitions are always challenging, more so in this case. I think we should credit the management for restoring the confidence of the clients and investors."

B.SNIPPETS

Financial Globalisation : Retreat or Reset

Since 1980, an unprecedented wave of global financial integration has linked national financial markets. Although the process was significantly accelerated by the creation of a monetary union and a single currency in Europe, financial integration has been a global phenomenon.

However, in the wake of the global financial crisis, cross- border flows have plummeted and currently the global financial markets seem to be at an inflection point . As a McKinsey Global Institute report argues: “One path leads to a more balkanized structure that relies primarily on domestic capital formation and concentrates risks within local banking systems, while another points toward a healthier model of financial globalization that corrects the pre-crisis excesses while supporting more robust economic growth.”

Financing Cancer Research

Andrew Lo of MIT has proposed an idea to create a “megafund” that would support early- stage research in cancer drugs with $30 billion. It will support as many as 150 experimental compounds at any given point of time, bring in a large number of investors, and spread risk over a much larger base.

Lo estimates that even if just a few of the drugs prove effective, the fund would earn equity investors annual returns of 7 to 10 percent. In a paper published in the *Journal Nature Biotechnology*, Lo said, “Only with massive scale can you reduce the risk of this early- stage research.” He added, “Finance is a means to an end. It’s a way to allow us to collaborate on problems of unprecedented scale.”

According to the Lo’s proposal, the oncology fund would pour more money into more speculative early- stage research in return for a percentage of future royalties on proceeds from sales of intellectual property. Lo has suggested creating a new kind of investment instrument: “research- backed obligations,” or RBOs, involving a mix of equities and debt securities to maximize capital, spread risk, and produce different levels of returns.

Equity Premium : Four Different Concepts

The term ‘equity premium’ or ‘market risk premium’ is used to designate four different concepts:

1. Historical equity premium (HEP): This is the historical differential return of the stock market over treasuries.
2. Expected equity premium (EEP): This is the expected differential return of the stock market over treasuries.
3. Required equity premium (REP): This is the incremental return of the market over the risk – free return required by an investor. It is used for calculating the required return to equity.
4. Implied equity premium (IEP): This is the required equity premium, if the market price is assumed to be correct.

Trends in Global Value Chain

There are four major trends in global value chains:

1. Since the early 1990s, international fragmentation, as measured by the foreign value- added content of production has increased.
2. A greater proportion of value is being added by capital and high- skilled labour and a less proportion of value is being added by less- skilled labour.
3. Advanced nations, as the theory of comparative advantage would suggest, are increasingly specialising in activities performed by high- skilled workers.
4. Surprisingly, emerging economies are specialising in capital – intensive activities. Hence, while the share of capital in their value added is rising, the share of low- skilled labour in their value added is declining

C.WIT AND WISDOM

1. Humour

- A large computer- oriented company has the following entry in one of its ledgers: "This correcting entry is to correct an incorrect correction made incorrectly in January."
- A professor went to his class, wearing one black shoe and one brown shoe. An amused student pointed toward the odd combination. The professor replied, "This is not strange. I remember to have left a similar pair at home."

2. Wise Saws

- The greater the difficulty, the more the glory in surmounting it.
- Trying to get without first giving is as fruitless as trying to reap without having sown.