Investor view

Insights from the investment community

Issue 7 - Narrative reporting and spotlight on accounting policies

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Narrative reporting: cohesiveness of 'the story' and spotlight on accounting policies

The figures presented in the annual report tell us about the entity's financial performance in the year, but numbers alone are not enough. Investors also rely on the accompanying narrative to understand the complete picture. How clearly do your financial statements communicate the reality of your accounting policies to users? This 'Investor view' looks at some of the ways management can improve the cohesiveness of the messages delivered in the annual report and highlights some opportunities for improvement in these disclosures suggested by a number of senior investment professionals. These become further more relevant this year when you would start preparing your financial statement as per Revised Schedule VI.

A single narrator

The preparation of the annual report is a collaborative effort, built on contributions from various departments and from people with different operating focuses. However, conversations with investors suggest that this 'silo' approach to reporting can give the impression that management, and the information that they use to monitor the business, is not well integrated.

The challenge to management is therefore to provide a fluid and coherent discussion that does not suggest the information has been written by a number of departments.

A tale of two halves

Inconsistencies often arise between the information presented in the front half of the report and the information in the audited back half. For example, is the picture of performance painted in the narrative review consistent with that portrayed in the back of the report? Is there any linkage between strategy, risk, KPIs and remuneration?

Investors tell us that a lack of a cohesive message between the front and back halves of a report can create confusion and impact the entity's valuation.

Perhaps more importantly, they tell us that it can reflect badly on management; it might indicate a lack of joined-up thinking and controls within the entity; or, in the worst case, an intention by management to mislead the market.

The coherence of the picture of performance presented by management is also an area of focus for regulators. For example, the US and UK regulators have noted inconsistencies in segment reporting under IFRS 8, 'Operating segments'. Areas that caused confusion included where:

- A single segment was reported although the group appeared to be diverse, with operations in different countries.
- The operating analysis in the front half did not appear to be reflected in the presentation adopted in the financial statements.
- The narrative reports focused on non-GAAP measures although the segment disclosures were based on US GAAAP/IFRS amounts.

Balance and consistency in messaging are increasingly the refrain of investor and regulator alike.

Tying in non-GAAP measures

Non-GAAP measures such as 'operating earnings', 'cash earnings', 'earnings before one-time charges' and 'EBITDA' (earnings before interest, taxes, depreciation, and amortisation) are very commonly used by management to communicate their performance.

Interviews' with investors underscore their desire to see such numbers firmly tied back to the financial statements. For example, PwC's survey of the investment community ('Performance statement: Coming together to shape the future', 2007) highlighted the key attributes of credible non-GAAP reporting. Top of the list was the need to reconcile non-GAAP items to GAAP.

Investors also need to be convinced that there is just cause to adjust a GAAP measure. Good practice today includes:

- explaining why a non-GAAP measure is presented;
- defining key terms used;
- reconciling to GAAP;
- linking, where appropriate, to strategy and remuneration; and
- indicating whether the number reported is audited.

Joining the dots

In some instances, reporting requirements, or simply the complexity of a business structure, can lead to information on a given topic (such as risk) being scattered around various places in the report. Investors tell us that their frustration in navigating through a document can be eased greatly with good cross-referencing.

"I need to know how the revenue policy relates to the different products and services offered by the entity."

Breaking the mould

Investors believe that management commonly provides boilerplate accounting policies in annual reports. This can leave investors struggling to understand how the key transactions of the firm are treated.

Rather than simply confirming the entity's compliance with standards, investors would welcome critical accounting policies being put in the context of the business.

"Unearthing changes in accounting policies can be like trying to find a needle in a haystack."

"Wouldn't it make sense to have the accounting policy next to the relevant note?"

Connecting the dots: navigation and cross-referencing

Information on specific topics is often scattered in a number of places in an annual report. A report drawn at random by our team, for example, found the company's risk disclosures in 15 different places.

Investors would like to see related information presented in one place in the report. Where this is not possible, clear links to where additional information is located would be helpful. This question of "geography" applies equally to accounting policies. Rather than providing all accounting policies at the beginning of the notes, management might include each policy in the related note so the reader can consider them together.

Focus on change and choices

Where a GAAP allows a choice of policies, management has the opportunity to help investors understand not simply which path it has chosen to take, but why.

Many policies will be applied and disclosed consistently from one year to the next. While the accounting standards require disclosure of the policies that have changed or are new in the year, the investment professionals we talked to suggest that management:

- Explain why the policy has changed.
- Discuss more fully the impact of that change on the numbers reported.
- Give due prominence to those policies that have changed.

Communicating culture

When talking to investors, we frequently hear mention of the 'look and feel' of a report. They express a desire for a report that reflects the culture of the reporting entity – and not the layout preferences of their external design team. 'Business-like' appears to be preferred to an excessive emphasis on the 'glossy'.

In general, investors would appreciate the notes being prioritised in order of importance. Investors also find it helpful if the information provided within the notes is prioritised, with the key messages at the beginning of the note followed by the detail and further disaggregation. Given this, management may consider it useful to include the accounting policies – if they remain consistent from one annual report to the next – at the end of the notes or within the related note as described above.

Contact your local PwC office to discuss these issues and visit:
http://www.pwc.com/in/en/services/IFRS/IFRS-in-India.jhtml
to read other editions of 'Investor views'.

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