Writing the narrative: the triumphs and tribulations

By Afra Sajjad

Introduction

In recent years, particularly since the advent of the global financial crisis, the debate has grown over whether annual reports have relevance to investors and other users, and enable them to make proper decisions on companies' prospects. To bridge the perceived information gap, and to satisfy the information requirements of the standard setters, narrative reporting has come to the fore.

In its various guises – Business Review, Management Commentary, Management Discussion and Analysis, Chairman's Statement, Corporate Governance Statement, Environmental Statement, Remuneration Statement, and Health and Safety Statement – narrative reporting is now a significant segment of the annual report in many parts of the world. It has supplemented and complemented financial statements by including prospective and retrospective information on a range of key issues: including the business model, strategy and structure, customers, human resources, innovation, brands, intellectual assets, supply chain, economic performance, operating performance, environmental, social and ethical performance, risk and uncertainties, and corporate governance. This disclosure been made in various formats – text and figures, illustrations and graphs, key performance indicators and case studies – and has become increasingly voluminous.

This extension of narrative disclosures in annual reports has in turn raised questions on whether businesses' substantial investment in data collection and the production of narrative reports is justified. Does narrative reporting succeed in enhancing the value of annual reports to its primary users of annual reports?

Narrative reporting – the current predicament

The International Accounting Standards Board's (IASB) IFRS practice statement Management Commentary explains narrative reporting as an opportunity for the management to explain its objectives, and strategies for achieving those objectives, by providing a context within which to interpret the financial position, financial performance and cash flows of an entity. It identifies the provision of decision-useful information to current and potential investors as the principal characteristic of narrative reporting. A quantified, evidenced, future oriented, cohesive, balanced and relevant narrative report facilitates an understanding of the businesses model of a company. It should enhancing the relevance of corporate reports while at the same time nurturing trust between the preparers and users of annual reports – and so in theory should be instrumental in developing and maintaining corporate reputation.

But a study carried out by ACCA and Deloitte in 2010, *Hitting the notes, but what's the tune?* showed that the average length of annual reports of UK listed companies has increased by 56% over the period 1996-2010, half of which is taken up by narrative reports. This voluminous expansion of narrative reports has, far from enhancing the usefulness of annual reports, become considered as one of the main reasons for increasing complexity and reducing usefulness of annual reports. Regulators, policy makers and users have expressed concerns that these reports have typically become generic 'boilerplate' disclosure documents resulting in unnecessary immaterial clutter and information overload. The business story is lost and the lengthy disclosures and regulatory jargon of narrative reports become part of the problem, not the solution.

Narrative reporting – the fallen frontier

So how has this happened? The ACCA/Deloitte report surveyed finance leaders in their role as preparers of reports in nine separate jurisdictions, and revealed that the equal importance with which the (at times) divergent and competing needs of regulators and shareholders pose a real dilemma for companies. Shareholders may be perceived the most important audience of narrative reports (as with financial statements) but compliance with legal and regulatory requirements are considered equally crucial. As preparers struggle to balance the competing demands, more and information is disclosed in narrative reports resulting inevitably in clutter and information overload.

The reliability of narrative reports has been a persistent concern. Unaudited narrative reports have been criticised as self serving, overly optimistic accounts of business performance and position. A key finding of the ACCA/Deloitte report was that reliability of narrative reports would be enhanced by an external auditor opinion. While statutory financial statements are externally audited, the lack of verification of narrative reporting cause reservations about the transparency of disclosure. And whereas financial statements preparation is governed by IASB standards, the absence of clear guidelines governing narrative reporting accentuates fears over reliability of disclosure. The IASB has come up with a non-mandatory practice statement, and we will have to see if this proves to be sufficient to assuage the fears.

The recent debate on usefulness of narrative reporting has focused on whether corporate reports provide sufficient information to users of annual reports to make an objective decision about the business models. As the business model is, to put it simply, a way of doing business, disclosure would have a pervasive effect on all aspects of a business's operations: the competitive and legal environment in which it operates, its place in the supply chain, the nature and level of its engagement with key stakeholders, the quality of its board of management, its commitment to sustainable development, and the actual products and services it delivers. Business model disclosure could offer retrospective but more importantly prospective decision-influencing information by explaining the infrastructure, the networks, the resources that drive the strategic direction, the business differentiators and value drivers, the implementation of the unique value proposition, the profit margins, the cash flows, and the associated internal and external risks.

But the ACCA-Deloitte report showed that whereas businesses are disclosing retrospective information about corporate governance, remuneration and financial position and performance, there are concerns over the quality of information about various elements of business model - for example risk, strategy, resources, relationships and importantly forward looking plans do not seem to be priorities. So if businesses are still not disclosing the essentials of business models, then the benefits of narrative reporting will seen to be outweighed by its costs.

Narrative reporting – the future state?

The ACCA/Deloitte report finds from respondents a strong preference for a reporting environment where there is more discretion and less regulation. The usefulness of narrative reports would also benefit from the inclusion of external audit opinion and guidance from the IASB. Thus it seems that the future of narrative reporting lies in identifying through engagement between the relevant stakeholders the right balance of regulation and discretion. The former would need to be combined with an enabling discretionary environment that facilitates excellence through preparers' honest creative innovation and orientation towards shareholders' needs.

Skills and knowledge of auditors and preparers are also an issue. Do auditors have the necessary training and knowledge to audit narrative reports? And preparers, generally unguided by any conceptual framework and grappling with regulatory requirements, have h knowledge and skills gaps still to be bridged if they are to come up with decision-useful reports that encompass a compelling story of the business model. Reflecting on their predicament would enable narrative reporting finally to accomplish its true aim of helping the primary users of annual reports form an objective judgment on the future of the business.

The ACCA/Deloitte survey shows that finance function plays a major role in the preparation of narrative reports. As annual reports have traditionally comprised of financial statements only, the preparation of such reports has been the prerogative of the accountants. But as the boundaries of annual reports have expanded, the role of accountant as value creators across organisations, and promoters of sound business practices that drive business performance has undergone metamorphosis. It appears that as reporting has moved beyond historically focused, number-driven content, a significant number of organisations appear to have widened the scope of the finance remit and/or the finance function. But the evolution of annual reports from their original focus on financial performance to a new emphasis on business performance has to be complemented by expansion of the skills and knowledge set of the finance/accounting professionals who prepare the narrative reports.

ACCA and narrative reporting

ACCA has always considered narrative reporting to have great potential for enhancing the understanding of users about the performance and financial position of the reporting entity. In the context of creating this wider understanding of a company's position and performance, ACCA is committed to promoting the disclosure, by companies and public bodies alike, of non-financial information where this is relevant and proportionate. We believe, as a matter of principle, that to require entities to report publicly on specified matters acts as an incentive for the entities concerned to take those matters seriously and to improve its practices on a continuing basis.

With this in mind we have campaigned over a number of years for the obligatory disclosure by relevant entities of information on social and environmental matters, and welcomed the decision to incorporate disclosure requirements on these matters in the Companies Act 2006 and the Climate Change Act 2008. We have participated in and supported the development by the Climate Change Disclosure Board of its new reporting framework, and are actively involved also in the work of the International Accounting Standards Board, Global Reporting Initiative, Accounting for Sustainability and the International Integrated Reporting Committee. While there is much development work to do, the latter project offers the opportunity, in the medium to long term, to achieve a radical step forward in the scope of corporate reporting.

We believe that the future of narrative reporting lies in reconciliation of competing information needs and expectations of primary users of annual reports i.e. regulators and shareholders. This should be accompanied by nurturing of a culture of corporate reporting where integrity, probity and transparency are fundamental to reporting. Regulators also need to facilitate change in the culture of reporting by giving preparers the flexibility to use discretion and facilitate market led best practices. Shareholders as the users of annual reports desire balanced and reliable information about risks, business model and future, but they need also to be mature enough to encourage real transparency. If they respond with panic to disappointing news, it will inhibit the preparer's disclosure process. All parties need to focus on creating a narrative reporting model with a principles-based approach to regulation and production of corporate reports which all users, including investors and regulators, find relevant.

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