

# Narrative Reporting: Analysts' Perceptions of its Value and Relevance





# **Narrative Reporting: Analysts' Perceptions of its Value and Relevance**

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<b>Glossary</b>	
Buy-side	Consumers of analysts' reports (including narrative and forecast data) such as fund managers.
Corporate governance reporting	Annual report disclosure containing information relating to corporate governance and reported compliance with corporate governance codes. Sometimes of interest because it contains details of directors' rewards.
Equities	Issued share capital of public companies traded on the equities markets (London Stock Exchange, etc.)
Equity research	Production of forecast information by sell-side analysts primarily cashflow and profit based measures, and management strategy to support buy/sell/hold recommendations and reports on equities.
Forecasting	Future profit and loss, cashflow and balance sheet predictions based on current available accounting information and management comment.
Front end	Annual report sections devoted to voluntary disclosure narrative prior to statutory reporting sections typically starting with the directors' report.
Fund managers	Individuals within investment companies, assurance and pension funds responsible for equity, debt, cash and other financial instrument allocation and selection within funds under their management (managed funds).
Information 'supply chain'	The process of production of accounting information (by preparer companies), its interpretation (by sell-side analysts) and its consumption (by buy-side). The consumption and use of accounting and other annual report information from companies used by sell-side analysts for their equity reports and recommendations to buy-side funds.
Mandatory/statutory disclosure	Reporting compliant with relevant reporting standards and regulatory/legislative instruments.
Preparers	Public companies that publish reporting data compliant with relevant IFRS and legislative frameworks. Annual reports also include voluntary narrative disclosure.
Risk reporting	Voluntary reporting relating to risks that companies are exposed such as financial and operating risks and their management of those risks.
Sell-side	Producers of equities research and forecasting data for consumption by fund managers and other buy side participants.
Social and environmental reporting	Voluntary disclosure containing information on the company's impacts upon a range of social and environmental constituencies or stakeholders. Typical contents include information on human resources, communities, environmental resource consumption and environmental impact.
Strategy reporting	Information containing detail on the company's strategy. Typically forward looking in tone, it is more likely to be present in the chairman's statement or the chief executive's statement in an annual report.
Voluntary disclosure/narrative	Information provided by companies within annual reports not covered by statutory reporting requirements including social, environmental and risk disclosures

# Executive summary

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## 'Analysts like numbers, to be honest'

ANALYST A9

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### INTRODUCTION TO THE TOPIC

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This research report is about the voluntary narrative sections of company annual reports, with particular reference to the annual reports of UK banks. Voluntary narratives are defined as those parts of the annual report not mandated by Companies Act requirements and not reported on as part of the audit report. Such disclosure narratives include, among other things, the chairman's statement, chief executive's review, social and environmental reports, and risk disclosures. There is an academic literature that has examined the patterns of voluntary disclosure and these contributions have fallen roughly into three general categories: empirical studies examining trends and changes in reporting; theory building and testing contributions; and user-needs analyses. It is to this latter strand of literature that this study aims to make a contribution.

There has been a marked growth in many types of voluntary and narrative reporting in recent years, with media other than the hard copy annual reports in the ascendant as carriers of reporting messages. Despite this growth, large companies continue to produce elaborate, lengthy and detailed annual reports with narrative sections extending to, in some cases, hundreds of pages. The annual reports for 2006 of HSBC Holdings plc and Barclays plc were 458 pages and 310 pages respectively.

One of the questions frequently raised, but not well answered, in considering this growth is the actual usefulness of this surfeit of narrative in annual reports. Who reads it, is the information useful and is it material to fund allocation decisions made by investors? And if not, what are the implications for preparers of annual reports?

### AIMS AND OBJECTIVES OF THE RESEARCH

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The primary aim of this research is to explore questions of usefulness and materiality of annual report narrative disclosures. The research addresses calls made by, among others, Smith (2004: 202), who suggests that, 'future research will more widely examine the discretionary disclosures made by firms to explore their impact on decision makers and on investment analysts' stock recommendations'. In order to do this, a method was chosen that would facilitate an in-depth and narrative-rich discussion of the issues in question with perhaps the single most important and influential user group of audited and narrative company reporting: sell-side analysts.

The sell-side's role as the primary interpreter of company information for buy-side and fund management purposes makes it a suitable source of opinion on the research question, as it is the sell-side's consumption of corporate reporting upon which fund allocation decisions are ultimately made. Given that, in volume terms, most institutional 'real money' changes hands on the basis of sell-side advice, sell-side analysts are uniquely placed to comment on the investment materiality of a range of voluntary narratives and it was upon that basis that they were selected for this study.

Nineteen London-based sell-side analysts were interviewed between late 2004 and mid 2006, each of whom analysed only the banking sector. The focus on the banking sector was for several reasons, prominent among which was the fact that banking (along with technology, pharmaceutical and oil/gas) is one of the four main 'volume' trading sectors in London, strategically important to the UK economy and comprising approximately 15% of the total FTSE 100 market value. It was further believed that focusing on one sector rather than performing a shallower cross-sectional study would enable a greater penetration to be made of issues relevant to materiality in that single sector. All analysts were interviewed using a semi-formal method, and interview transcriptions were content analysed and sorted by the category of voluntary disclosure being discussed.

## SUMMARY OF FINDINGS

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Each analyst expressed views on a range of voluntary and narrative disclosure categories, including management commentaries such as the chairman's statement, chief executive's review, operating and financial review, risk reporting and the corporate governance statement. In addition, other areas of voluntary narrative were discussed at some length including social, environmental and ethical reporting (partly because these issues have preoccupied many academic researchers in the field).

There was a general belief that narrative reporting was not immediately applicable nor helpful in the primary tasks of the sell-side which is to construct forecast models and produce written reports for the buy-side. The normal view was that narrative reporting was less useful to analysts than to other putative users of annual reports but most analysts were unable to identify specific consumers of any given disclosure category.

The chairman's statement was generally considered to be less useful than the chief executive's review because the latter was more likely (in most annual reports) to contain meaningful information on future strategy. The content of the chairman's statement was generally dismissed as irrelevant to the investment decision or to any forecasting figure. Risk disclosure was generally thought of as too general in nature to be useful. Corporate governance reporting (mandatory under listing rules under UK 'comply or explain' practice) was usually unread because governance in UK banking was generally trusted by the analysts. Social and environmental reporting was universally considered irrelevant and incapable of influencing a financial forecast. It was rarely read by analysts and any suggestion that the environmental reporting might contain disclosures germane to the description of secondary (ie loan book) environmental risk was dismissed.

## IMPLICATIONS OF FINDINGS

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Analysts were shown by this research to be technocratic and rules-driven in nature, and unlikely to be a source of change in respect of social and environmental issues. They were generally sceptical about all voluntary narrative reporting and were dismissive of large sections of it as irrelevant, 'useless' or worse.

There are a number of issues raised by the findings. Prominently, these findings represent a challenge to preparers of annual reports, who have presided over a period of volumetric expansion of narrative content, the value of much of which to analysts can now be questioned. If it is the intention of preparers to make narrative reporting relevant and material to investors, they appear to have some way to go or some rethinking to do.

Similarly, however, the findings highlight the way in which analysts are dismissive of anything other than directly value-relevant numerical data. The belief that no narrative reporting is capable of informing, amending or challenging a financial forecast is a curious one.

# 1. Introduction

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**'You're never satisfied with what you're given. You always want more. That's it, end of story. You always want more. You always want the better description, you want more granularity, you want more information as an analyst to get a better understanding of what's going on in the business.'**

ANALYST A5

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There is a growing tradition of research in voluntary disclosure of accounting information. Several themes or genres of research can be identified in the literature with those prominent including descriptive studies, theory testing and user-needs analysis and perspectives. Descriptive studies are those that have noted changes and trends in various aspects of reporting behaviour; theory-testing studies are those that have attempted to use reporting evidence to inform a variety of theoretical perspectives; while user-perspective studies have sought to identify user needs and measure reporting against those needs. This study seeks to make a contribution to the last of these three genres.

## 1.1 THE INFORMATION 'SUPPLY CHAIN'

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The passage of information from reporters to consumers of corporate information is a complex one but an approximate 'supply chain' can be identified, at least as far as institutional stock market participants are concerned. The situation is slightly different for some individual and smaller investors.

The reporting company makes disclosure through a number of media. These will typically include analysts' briefings at the time of the publication of the results, interim accounts, final annual report and accounts (usually several weeks after the initial analysts' briefings), 'stand alone' reports and press statements made to the press or through the investor relations department. Most of the financial information used by analysts is made available at the results publication date, some weeks ahead (usually) of the publication of the annual report, and the annual report is mainly used, where it is used at all, for its narrative content and small items of financial information not in the preliminary results (such as board members' salaries).

On the basis of their reading of a company's financials and other strategic information, sell-side analysts provide advice to buy-side clients. The formal channel for this is the analysts' report, produced to an approximate pro forma (although this may be disputed by some analysts) and it is common, although obviously not compulsory, for this to be shown to the subject company's investor relations department being analysed, prior to publication.

The investor relations department may then suggest amendments before the report is published.

Publication is commonly through subscription-based online sources that are available to the buy-side although informal contact also takes place where more robust views on individual stocks might be exchanged. The analyst's report, as a document in the public domain, tends to be carefully worded. But in the event that 'coded' statements are not understood by favoured buy-side clients, the informal contact conveys enriching information over and above the formal report.

Sell-side analysts are a key part of the information 'supply chain', and the basis for the primary research undertaken for this report. Their importance in the 'supply chain' has been recognised in the academic literature. Johansson (2007: 30), for example, comments that: 'sell-side analysts are ... key actors in this market and the analysts' relations with company representatives and clients seem to be a central part of the value-creation chain in the market'. Jackson (2005) and Ljungqvist et al. (2007) also both recognise the primary role of the sell-side analyst acting as an information intermediary in the investment process. Lui et al. (2007: 630) say that: 'given that [sell-side] analysts have been shown to influence investor behaviour and given the importance of risk in making investment decisions, an empirical investigation of analysts' risk assessments seems long overdue. In general, analysts add value by both aggregating publicly available information and generating new information.' In the professional and practice media, Investor Relations Society (2003) commented that: 'sell-side analysts remain an important audience for corporate communications. Sell-side analysts still play an important role in the market'.

The buy-side makes use of a number of sources of information but tends to rely quite heavily on sell-side analysts' reports. Most investment houses impose restrictions on share dealing behaviour by fund managers that goes against the explicit advice of the sell-side. Because fund managers typically deal in many stocks at a time, they use direct company information only intermittently. Although a fund manager may read an annual report for a particularly important stock, this is not



a systematic activity and so the sector- and company-specific information provided by the sell-side is seen as very important.

The polling organisation MORI conducted a survey for the Financial Services Authority in 2005 that involved 300 interviews with respondents at buy-side organisations. The initial question posed was: 'How important would you say investment research produced by sell-side institutions is as a source of information and ideas about the companies, sectors or assets you follow or invest in?' (FSA 2005: 20). The responses demonstrated the importance of the sell-side to the buy-side, with 29% viewing sell-side research as 'very important' and 52% as 'important'. Only 14% of respondents viewed sell-side advice as 'unimportant'.

Similarly, Ethical Corporation reports, 'the role of sell-side analysts is seen as crucial, as their views are given weight not only by asset managers, but also by high-level managers in companies themselves' (Schiller 2005). This practice-based research is consistent with the findings of Womack (1996) and, more recently, Johansson (2007) who examine the role of sell-side analysts in the information supply chain. Johansson (2007: 31) says that: 'in a short time perspective, the analysts' recommendations seem to influence the price of a stock, and, according to studies on the market level, their written recommendations tend to convey valuable and new information.'

The buy-side will typically receive several analysts' reports, through the online subscription provider, on any given sector or stock. Over time, favoured analysts will be followed and less favoured ones will not. In each case, however, the buy-side will typically look for 'snippets' of research 'over and above' the template or pro forma. Advice based on experience beyond the financial information is valued, although because of the politics of the relationship between analyst and company this is often difficult to provide. This brings us, however, to the next section.

## 1.2 THE RELATIONSHIP BETWEEN COMPANIES AND ANALYSTS

In the information 'supply chain' then, the sell-side analyst is the primary interpreter of company reporting. Given that fund managers, who are the actuators of fund allocations, do not systematically study company information directly, there is a heavy reliance on analysts' interpretations of company situations and financial performance forecasts.

There is a tension in an analyst's role between independence from a company being analysed and his or her dependence on the company in terms of information provision and general relations. There are a number of reasons why analysts send their reports to the analysed company prior to publication. The most prominent reasons are relationship management and checking for accuracy. The investor relations departments may make suggestions but if the analyst feels the need to say something negative

in the report he or she must balance the strength of the wording with the need to manage the relationship with the company over the longer term. It is thought that senior company officers have their 'favourite' and 'most trusted' analysts that, it is believed, are the most likely to receive communications and information confirmations at key times. Inasmuch as such information can be a source of competitive advantage for an analyst, the management of that relationship, over many years, is very important.

It is conceivable, therefore, that some information germane to investment decisions is expressed in less than direct terms and in terms capable of being overlooked or missed altogether. Such 'soft-peddling' in the interests of relationship management may be a source of concern to some observers in respect of the independence of analysts.

One of the analysts in the study (Analyst A2), speaking anonymously, was robust in his/her description of the company-analyst relationship, describing it as 'adversarial'.

*Analysts and companies are adversarial. The role of the analyst is to act on behalf of the investor and the analyst must expect that the company is potentially going to mislead them and therefore you have to take whatever they say with a significant amount of salt and you have to be looking for signs where perhaps numbers that they are forced to report... do not match up to management statements or other numbers that they've published.*

It seems to be the case, then, that a balance exists between analysts' need to cultivate long-term relationships with the companies they cover and the need to maintain a healthy detachment and scepticism. The possibility that companies may seek to 'mislead' investors places analysts in a very important position in the information supply chain, as it is they who must interpret and discover such behaviour on behalf of those further down the supply chain that depend on their advice. Such a situation is explicitly recognised by Ljungqvist et al. (2007: 421) who state that:

*companies care about what the analyst has to say about their stocks and could take their investment banking business elsewhere if they are unhappy with the analyst's opinion. Thus sell-side analysts who work for integrated investment banking houses could come under implicit (or occasionally explicit) pressure to publish more favorable [sic] research about their employers' current or potential relationship clients to help boost investment banking fee revenue.*

This problem of the objectivity trade-off with relationship management and trade generation is discussed at length by Jackson (2005), Lin and McNichols (1998), Ljungqvist et al. (2007), and Michaely and Womack (1999).

The reciprocity between company and analyst was discussed by several interviewees in the cohort used in this study. Analyst A16 was asked whether he or she

believed that company finance directors were concerned about what analysts said about them.

*I think they do care because I think a lack of disclosure at some level effectively puts up their cost of capital. I think it's a genuine driver and they know it. Companies with the most open, best disclosure, everything else being equal, tend to see a higher rating and that's, I think, something you can start to show.*

### 1.3 THE CHANGING ROLE AND CONTENT OF THE ANNUAL REPORT

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Much of the prior research in voluntary disclosure has taken place in the context of the corporate annual report. Although voluntary disclosure on a range of issues takes place through media, including advertising, public relations documents, websites, special reports, press statements and through informal channels, research has centred on the annual report for several reasons. These have included the notion that as the only statutory annual communication with shareholders, anything considered important enough to be said would be conveyed in that document. Given that the company has almost total editorial control over the narrative content of the annual report, it is assumed to be the representative medium of a company's overall reporting intent. Botosan (1997: 331) notes that, 'the annual report is generally considered to be one of the most important sources of corporate information' while Gray S. J. et al. (1995: 45) goes slightly further, suggesting that, 'the annual report is a significant element in the overall disclosure process, given that it is the most widely disseminated source of [company] information'.

Annual reports have grown in length over the past recent decades. Campbell et al. (2006) reports that the average length of an annual report rose from 37 pages in 1974 to 90 pages in 2000. As they have grown in length, content has been added in response to a number of supposed information demands from users. The general expansion of explanatory notes to the accounts and the requirements under different corporate governance code provisions for more information have been accompanied by some additional requirements under recent companies acts and listing rules. In addition to legal, regulatory and statutory content, however, annual reports have been noteworthy in recent years for the increased amount of narrative reporting, 'the importance of [which]... by listed companies is expected to increase in the future' (Beattie et al. 2004: 232). Increased narrative reporting is thought to be related to the increased public scrutiny of business activities and the assumed need to explain various aspects of activity not amenable to numerical conveyance. Beattie and Pratt (2002: 1) note that, 'the importance of narrative reporting in annual reports has significantly increased' while Clatworthy and Jones (2001: 311), similarly, find that, 'accounting narratives are becoming increasingly important in external financial reporting.'

Gray S. J. et al. (1995) highlight the importance of distinguishing between types of information in examining

voluntary disclosures. The voluntary narrative reporting categories that have attracted the attention of academic researchers include:

- risk reporting (eg Cabedo and Tirado 2004; Linsley and Shrives 2005; Linsley and Shrives 2006; Schrand and Elliot 1998; Woods 2004)
- the content of the chairman's statement (eg Arnold and Moizer 1984; Day 1986; Rippington and Taffler 1995; Smith and Taffler 2000)
- a range of other content that can generally be regarded as social, environmental and/or ethical in nature (eg Beattie and Pratt 2002; Deegan and Gordon 1996; Deegan and Rankin 1999; Gray, R. H. et al. 1995; Miles et al. 2002; Milne and Chan 1999; Solomon and Solomon 2006).

Previous academic studies have taken the opportunity to examine some of the trends and changes in these narrative reporting categories (see for instance Gray R. H. et al. 1995; Lehman 2004) and some have attempted to theorise links between changing reporting practices and changes in society in general (see for instance Patten 1995, Deegan and Gordon 1996, Wilmshurst and Frost 2000; and O'Donovan 2002). While several such studies have been published, few of them have addressed the issues of the materiality or usefulness of the increased narrative disclosures. It is to this genre of literature that this research report is intended to contribute.

Although academic studies have examined patterns in these disclosures, relatively few have examined the manner in which they are used by capital market participants. The prominent studies relevant to this research are detailed in the following literature review. Although a number of studies have sought, with varying degrees of success, to interrogate the views of a range of capital market participants, this report is one of the first to gain systematic evidence directly from the sell-side.

The importance of this study is also underlined by the growth in other media for corporate reporting purposes. Whereas at one time the annual report would be the only public document produced by companies (except for those that produced advertisements and other marketing literature), the changing landscape of corporate communications has reinforced the importance of questions on why the annual report is a suitable vehicle for some narrative disclosures. In addition to stand-alone social and environmental reports (which have emerged over the past decade or so), it is likely that the company website has become the vehicle of choice for most stakeholders seeking information on a company.

## 2. Literature review

### 2.1 ANALYSTS IN PREVIOUS RESEARCH

The position of sell-side analysts in the information 'supply chain' between reporting companies and investors has made them a suitable subject for a number of previous studies. As a cohort, analysts have been thought to be capable of speaking on the materiality of information, owing to their assumed role as interpreters of accounting 'numbers' and strategic intent.

As they are sophisticated users of corporate disclosures of varying types, Day (1986: 295) refers to analysts as, 'perhaps the most informed and articulate user group.' Their role in the flow of intelligence in capital markets is referred to by Fogarty and Rogers (2005: 331) who comment that: 'financial analysts employed by securities firms play an important role in the capital markets. Most importantly, the reports that they produce are given great consequence by many market participants'. Similarly, Vergoossen (1993: 219) remarks, 'since many investment decisions are based on their findings...investment analysts play an important role in the capital markets'.

This study is specifically concerned with how analysts regard voluntary disclosure narrative in the annual report. The debate between information sources and materiality has been evident in the literature for some time. In early studies, Lee and Tweedie (1975) and Firth (1978) both note that the annual report is an important information source for investment decisions, but both these studies were published prior to the development of other information sources used by analysts today, such as online sources and stand-alone reports. In the 1980s, Arnold and Moizer (1984) examined methods used by UK analysts to appraise equities. They find that the most used parts of the annual report are used for such purposes, with the profit and loss, and the balance sheet being the most used statements. This is consistent with the findings of Lee and Tweedie (1981) although again, being studies of their time, voluntary disclosures are not addressed (see also Bouwman et al. 1987).

Research into analysts' use of different information sources is reflected in the literature. In addition to examining which parts of the annual report are used by analysts, some studies ask about the relative importance placed upon the annual report compared with other information sources. In practice, 'other' information sources usually refers to direct contact with the reporting companies themselves. Inasmuch as direct 'personal' meetings for the disclosure of new information are unauthorised, 'direct contact' in this context tends to refer to analysts' briefings, contact with the investor relations department or direct contact with senior officers for the purpose of clarification and explanation only. A more detailed discussion of the extant literature addressing analyst use of annual reports now follows.

Several studies find that direct contact is generally considered more important to analysts (in terms of company analysis) than the information contained in the annual report. Pike et al.'s (1993) is typical of the studies

that find that personal contacts between analysts and corporate personnel are more important than the annual report. In most cases, however, analysts said that they placed the annual report second only to (ie immediately behind) direct contact in terms of the usefulness and materiality of its content (Chang and Most 1985). Barker (1998), similarly, finds that analysts attach less importance to the annual report compared with personal contact, results announcements and analyst presentations (by companies at the financial year end). The reason for this is that, 'the annual report doesn't satisfy analysts' short term news orientation' (Barker 1998: 12; see also Hellman 1996). A small number of other studies find responses at some variance to this 'order'. Brown (1997) finds the annual report to be the most important information source while Vergoossen (1993) finds that the majority of analysts rate, 'the most recent annual report as their most important source of information' (Vergoossen 1993: 229). Eccles and Mavrinac (1995) find, conversely, that the annual report is in third place behind direct contact and press reports in its importance as an information source.

Previous analyst studies that inquired about the section of annual reports of most use to analysts overwhelmingly find that the financials were the most used. Brown (1997) finds the income statement (profit and loss statement) to be the most useful annual report component. Chang and Most (1985) find the same in terms of the importance of the income statement and also find that the balance sheet and notes to the accounts are the next most important components. They go on to report that front end parts (such as narrative sections) are considered the least important, with the supervisory board report (directors' report in the UK) being noted as particularly insignificant. Previtts et al. (1994) note that sell-side analysts find the income statement and cash flow statements to be of most use, followed by segmental information by geographic area/business unit. They find that the usefulness of non-financial (narrative) information centres on quality of management, new developments and other changes. Other studies examining analyst behaviour in respect of voluntary reporting include Anderson and Potter (1998); Biggs (1984); Birts et al. (1997); Bouwman (1984); Bouwman et al. (1987); Flostrand and Strom (2006); Gray and Skogsvik (2004); Rogers and Grant (1997); Snyder (1999).

Flostrand and Strom (2006) compare 200 analyst reports to 200 matched annual reports to examine the relevance of non-financial disclosure and the use made of such disclosure by analysts in their company valuation process. Their approach highlighted valuation relevance, which is the information usefulness of disclosures to analysts (much the same as the research objectives of this current study). Valuation relevance allows for a discussion of factors that may not necessarily have a direct relationship with share price but nonetheless may be useful to analysts in their overall valuation process. On the other hand, value relevance rests on statistical relationships between information and market value. Murray et al. (2006) find that there is no direct relationship between share returns and disclosure, although longitudinal data do show a

relationship between consistently high (low) returns and the predilection to high (low) disclosure.

Earlier studies on the value relevance of voluntary disclosure find mixed evidence for the value relevance of voluntary, non-financial information. Gray, S. J. et al. (1995) find that non-financial information is directed more towards a company's social accountability, which can, in turn, have a bottom line significance and affect share value. Richardson et al. (1999: 21) develop a model of CSR to capital market responses, asserting that, 'the release of information about any value relevant aspect of the firm, including CSR, has a direct impact on the way in which markets for equity operate'. Rippington and Taffler (1995) examine the usefulness of the annual report and its impact on share price. They find that while there is little impact on share price of the annual report release per se, impact is highlighted from new information coming from the annual report, such as the chairman's report. For further discussion of value relevance see also Orlitsky and Benjamin (2001), Lorraine et al. (2004), and Toms (2002).

Reflecting on analysts' use of disclosures, Holland (1998) finds that private disclosure to financial intermediaries is a significant part of the information process (see also Solomon and Solomon 2006). On the limitations of annual reports, Holland says that, 'the financial report has become too complex, too large and too cumbersome for many users and a source of overload' (Holland 1998: 262). Despite this, the annual report is recognised as a central component in the disclosure system as a 'first layer of understanding' (Holland 1998: 264).

## **2.2 ANNUAL REPORTS' CONTENT AND READERSHIP**

There is a substantial literature on voluntary reporting in annual reports and a small but still significant body of research exists on the actual role of the annual report. In a research report such as this, it is stressed that it is not possible to present a full and exhaustive discussion of this literature but rather to introduce some of the key questions and findings from previous work by way of introduction to the main presentation of evidence from the analysts interviewed for this research.

An early call for research in this area is made by Day (1986: 295) when she concluded that, 'little [up to 1986] has been written about what users themselves appear to find useful [in an annual report]'. Work reporting on empirical studies, typically employing content analysis-based instruments for the recording of content, are usually unable to interrogate user perspectives, although these studies do provide the evidence that most categories of voluntary narrative were increasing over time. It was probably assumed that the intensification of scrutiny of the corporate sector generally was a major cause of increased reporting (Campbell 2004; Tilt 1994) but there was, until some time after Day's call, little evidence of user perspectives on the increased disclosure.

While a small number of studies analyse non-economic stakeholders' perceptions of reporting (eg Tilt 1994), the body of literature referred to in this report is concerned primarily with the reactions of stakeholders with an economic interest in the company. In particular, it refers to stock market participants' reactions to different categories of disclosure. The most frequent inquiry reported upon is that of investment materiality.

Something is known about the general consumption of information in corporate annual reports following work by Bartlett and Chandler (1997), Lee and Tweedie (1975), and Rowbottom and Lymer (2007). Both Bartlett and Chandler (1997) and Lee and Tweedie (1975) examine the behaviour of private investors rather than professional analysts. Both studies find little evidence that the annual report is systematically read, but the Bartlett and Chandler study (1997) finds that more voluntary disclosure is neither needed nor used. They single out the corporate governance section for specific comment, saying (p. 254), 'the sections relating to corporate governance seem to have had little impact on shareholders, with 31.9% reading the directors' statement of responsibility (but only 5.8% thoroughly), and even fewer (23.5%) reading the corporate governance section (though 8.8% read it thoroughly)'.

Rowbottom and Lymer (2007) use a website usage interrogation method to measure the download frequency of the major items in corporate annual reports, a method made possible by the fact that annual reports are broken down into downloadable 'chunks' on the websites. Based on a sample of 15 UK companies, Rowbottom and Lymer find that the most frequently downloaded items by all users (not distinguishing between types of annual report reader) are the compulsory financials. The least downloaded items include the chairman's statement, the environmental report and the chief executive's review. The data are shown in Table 2.1. The Rowbottom and Lymer (2007) study uses a cross-sectional sample of 15 companies, and their results provide an interesting illustration of the relative importance of the different types of annual report disclosure.

The research carried out with the bank analysts, fully reported on in Chapter 5 of this report, confirms the lack of attention given to some of the lower ordered items such as the audit report, chairman's statement and governance report. The contents of Table 2.1 and more specifically their order, should not be regarded as a 'shopping list' effect with the reader stopping when they have enough comfort in the 'basket'. Rather, it signals the materiality placed by users on individual sections of the annual report and its use. Moreover, the relative apparent immateriality of these items is subsequently confirmed in the research findings when the issue of having no 'front end' reporting is discussed with the analysts. There is little evidence that analysts find the 'front end' content to be material but, perhaps more surprisingly, there is little evidence that the voluntary contents are a source of 'comfort' to them either.

**Table 2.1: Annual report Web pages requested by users, in order of download frequency (2003 and 2004)**

Rank	Item in annual report (in order of downloads)	Type of disclosure
1	Income statement (P&L)	Compulsory, financial
2	Notes to the accounts	Compulsory, financial
3	Balance sheet	Compulsory, financial
4	Segmental analysis	Voluntary, <sup>1</sup> financial
5	Shareholder information	Voluntary, financial
6	Financial year highlights	Voluntary, financial
7	Company profile	Voluntary, narrative
8	Operating and financial review	Voluntary, narrative, financial
9	Five year summary	Voluntary, financial
10	Directors' report	Voluntary, <sup>2</sup> narrative, financial
11	Corporate governance report	Compulsory, <sup>3</sup> narrative, financial
12	Directors' biographies	Voluntary, narrative
13	Remuneration report	Compulsory, <sup>4</sup> financial
14	Chairman's statement	Voluntary, narrative
15	Chief executive's review	Voluntary, narrative
16	Cash flow statement	Compulsory, financial
17	Auditor's report	Compulsory, narrative
18	Statement of total recognised gains and losses	Compulsory, financial
19	Environmental impacts	Voluntary, narrative
20	Financial calendar	Voluntary, chronographic

(Source: Rowbottom and Lymer 2007).

1. Segmental information is now a mandatory disclosure under IFRS 8.
2. The Directors' report is mandatory but much of the content is voluntary.
3. Mandatory under listing rules under 'comply or explain' requirements.
4. Mandatory under listing rules under 'comply or explain' requirements.



## 3. Calls for research

### 3.1 CALLS FOR RESEARCH IN THIS AREA

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In general terms, previous researchers have identified and stressed the significance of the lacuna addressed by this research. In an early study examining the materiality of social disclosures, Milne and Chan (1999: 440) suggest that, 'little is known about the investment decision impact of narrative social disclosure that firms typically provide in their annual reports'.

More recent research has attempted to address the issue of voluntary narrative materiality but issues with direct access to information users have limited the reliability of findings. Ho and Wong (2004: 62) note that, 'few empirical studies [have examined]... the information needs of users and whether current disclosures satisfy users' needs', while Robb et al. (2001: 80) suggest that, 'further research about the usefulness of nonfinancial disclosures appears warranted'. Such calls were made in response to the limitations of previous research in interrogating the manner in which annual report narrative disclosures were actually consumed by users. Despite the studies described in the foregoing literature review, scholars in the area have been able to highlight the importance of the gap that this present study has attempted to address.

Parker (2005: 856) writes that, 'in terms of the future shaping of the research field itself, there would appear to be ample room for further applications of direct researcher engagement in the field, via qualitative research'. Similarly, Lorraine et al. (2004: 23) remark that, 'qualitative research which investigates companies', investors' and regulators' perspectives on these issues (environmental issues and value relevance) would be worthwhile'. In particular, however, this present research attempts to interrogate views on a range of voluntary narratives, partly in response to Beattie et al.'s suggestion (2004: 233) that 'it would be interesting to elicit from key user groups their views regarding... appropriate weightings to be assigned to each [voluntary non-financial disclosure]'. Accordingly, the importance placed by analysts on a range of categories of voluntary narratives is a key element in the research.

The remainder of this chapter examines the literature on the selected specific categories of voluntary disclosure probed in this research. It begins with that generally regarded as management commentary in nature and then proceeds to examine social and environmental disclosure.

### 3.2. MATERIALITY OF MANAGEMENT COMMENTARY, DISCUSSION AND STRATEGY REPORTING

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A number of disclosure narratives in annual reports are ostensibly intended to provide information on management commentary, performance, strategy, and related issues within these general remits. In all cases, excepting corporate governance and a number of provisions concerning disclosure in the directors' report, the content of these narratives is entirely within the editorial control of management. Unlike social and environmental narratives, which may contain information on non-financial or non-business related activities, management commentaries are all primarily concerned with business-related discussion.

Gray S. J. et al. (1995) suggest that voluntary disclosures can be considered to fall into three categories: strategic information, non-financial information and financial information. While 'capital market pressures do seem to bear on financial reporting practices' (Gray S. J. et al. 1995: 46) in respect of the belief that the cost of capital is thought to be related to disclosure (Botosan 1997), a lacuna appears to exist in the understanding of the manner in which voluntary management commentary is consumed and processed.

In the context of the annual report, disclosures in what Gray S. J. et al. (1995) refer to as strategic and non-financial, include the chairman's statement (the content of which is voluntary), operating and executive review contents, risk reporting and governance issues. The potential importance of these items to investors is significant, although existing research has highlighted a lack of understanding of how the investment community uses the information. Flostrand and Strom (2006) note that, 'the needs of users of business reports were no longer thought to be satisfied with...balance sheets and income statements... [but that] reports now had to include information relevant in predicting the future performance of the firm, whatever form or shape that information might have' (Flostrand and Strom 2006: 582). They continue, 'whilst there are studies testing levels of disclosure it is not known whether this information is useful to one of the primary users of financial information, namely sell-side financial analysts' (see also Vanstraelen et al. 2003).

Risk reporting, for example, is a relatively unexplored category of voluntary disclosure, partly because, as a separate section of the annual report, it is a relatively recent arrival. Whereas in earlier times, management might have mentioned risks in an unspecific, unsystematic or occasional manner, the idea underpinning a risk section of an annual report is partly that all the narrative on risk can be brought together in one place. The valuation of liabilities, provisions and contingencies remain, of course, an important part of the notes to the accounts but the description of risk takes place in the risk reporting section.

A typical risk section lists the risks that the company faces in relatively general terms and then may go on to explain, again in general terms, the way in which the risk will be managed by the company. This may include a note on the internal controls instituted to mitigate internally the effects of the risk. Despite the development of these separate sections, however, academic research has been generally critical of the information content of risk narrative. In particular, that it is too general and contains insufficient information in terms of a quantitative assessment of either the probability of the risk or the impact of the hazard (ie what would happen if the risk event was realised).

Linsley and Shives (2005) examine risk disclosure in UK annual reports and find that companies did not provide a complete picture of their risks in that 'there is minimal disclosure of quantified risk information' (Linsley and Shives 2005: 292). Similarly, Woods (2004) finds that, 'narrative [risk] disclosures are generic in nature... and current UK reporting practices are of limited help to users'

(Woods 2004: 373). Linsley et al. (2006) find that, 'general statements of risk management policy dominate the risk disclosures (which are not as useful as specific risk or risk management information)' (Linsley et al. 2006: 280), and they conclude that, 'overall the dominance of statements of general risk management policy and a lack of coherence in the risk narratives implies that a risk information gap exists and consequently stakeholders are unable to adequately assess the risk profile of a company' (p. 387). Schrand and Elliot (1998) point to the voluntary nature and the lack of accounting standards in risk reporting and conclude that companies have no incentive for voluntary disclosures of risk and that risk disclosure, accordingly, is incomplete.

The chairman's statement, similarly, has received a limited amount of attention in the literature. Aerts (1994) identifies the chairman's statement as an opportunity that companies sometimes take to make 'systematically biased' (Aerts 1994: 341) statements and to issue narrative that can be 'coloured' to manage news disclosure in the company's favour. In a later paper (2005), Aerts uses the term, 'self-serving attributional bias' to describe the impression-management efforts that companies, and chairmen in particular, use to manipulate audiences in respect of a particular interpretation of events. Courtis (1998) exercises similar language, referring to the chairman's statement narrative when introducing the 'obfuscation hypothesis'.

There does not appear to be any agreement among scholars as to actual materiality of the chairman's statement, and one reason for this is the intrinsic bias assumed to be a feature. Bettman and Weitz (1983) and D'Aveni and MacMillan (1990) produce contradictory findings when examining the text of chairmen's statements in companies that later went on to become bankrupt, indicating that the text and language style are not related to success or failure. Clatworthy and Jones (2001) challenge Courtis's obfuscation hypothesis when investigating the readability of chairman's statements in the UK. They cannot confirm the finding that disclosures of bad news were more difficult to read than good news. Smith and Taffler (1995), conversely, suggest that the narrative is a potential indicator of performance, although the messages conveyed by the chairman tend to embellish reality. They imply deliberate obfuscation attempts in communicating bad news. In another study, Abrahamson and Amir (1996) conclude that the chairman's statement is a source of 'useful information about the future of the company' (Abrahamson and Amir 1996: 1179).

The evidence for the usefulness of the chairman's statement is therefore mixed. While it can, in principle, be used to convey important strategic information to readers, academic studies that have content analysed chairmen's statements have found that they can be used for conveying biased content or messages that are ambiguous in terms of the future prospects of the business. The apparent scepticism in which the chairman's statement is viewed may be one of the causes of its seeming relative decline in importance in recent decades. Examining the relative importance of information sources used by analysts, the chairman's statement is ranked sixth most important item in an annual report by Lee and Tweedie (1981) and fourth by

Arnold and Moizer (1984). Day (1986) finds that the chairman's statement is ranked twenty-first as an item in the annual report referred to by analysts. Although (admittedly) not a direct comparison, Rowbottom and Lymer's study covering 2003/04 (Rowbottom and Lymer 2007) ranks the chairman's statement fourteenth, perhaps confirming a relegation of perception of this item in the minds of annual report readers.

### **3.3. MATERIALITY OF SOCIAL AND ENVIRONMENTAL REPORTING (GENERALLY)**

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As one of the most researched areas of voluntary reporting, social and environmental reporting has been studied from a range of angles and perspectives.

There is mixed evidence from the literature on the investment materiality of social and environmental (SE) disclosure. In an early call for research in this area, Dierkes and Antal (1985: 30) argue that, 'the ultimate test for the usefulness of social and environmental reporting information is its impact on decision making' and quite rightly note that at the time of their study there was 'a dearth of information on which to base an assessment of usefulness of this [social and environmental accounting]'. Those studies finding generally in favour of SE disclosure being of material interest to investors include Miles et al. (2002) and Solomon and Solomon (2006). Further, Murray et al. (2006: 229) find that, 'although social and environmental disclosure may not yet be an obviously substantive part of mainstream corporate activity, it is a growing concern to all parties.'

Solomon and Solomon (2006) examine the extent to which social, ethical and environmental (SEE) disclosure is integrated into institutional investment. Specifically, the study seeks to evaluate the, 'decision-usefulness of public SEE disclosure'. Based on interviews with 21 buy-side institutional investors, their findings include the observation that, 'there is not enough SEE information provided in company annual reports... [and there is] strong evidence that SEE information was decision-useful and would continue to grow in importance' (Solomon and Solomon 2006: 573). Miles et al. (2002) find a growing demand for SEE disclosure from the investment community and suggest that, 'demand for SEE information has been growing over time'. Further, Miles et al. (2002) argue that SEE disclosure is being increasingly used by institutional investors, underpinning a need to improve the quality and quantity of such disclosure in annual reports.

The stronger evidence from previous research is that which has found largely that SE disclosure is not investment-material in nature. The assumption made appears to be largely that SE disclosure is marginal, 'tagged on', or so perfunctory in content that the information it contains is scarcely of relevance to an investor audience (such as analysts). Murray et al.'s conclusions (2006: 246) include the reflection that, 'if further evidence could be gathered to suggest that markets can be persuaded to start to see the social and environmental implications of their financial decisions then... social and environmental disclosure [would] become a regular, significant and regulated part of corporate disclosure.'

Ho and Wong (2004) report on annual reports usage by Hong Kong-based investment analysts and find very little interest in non-financial voluntary disclosures, including social and environmental narratives. Beattie and Pratt (2002) report the views of analysts, shareholders, financial directors and audit partners of a range of disclosure items. Financial objectives and strategy are found to be the most useful 'with environmental, social and community trailing a long way behind... [and] not seen to be relevant to the investment decision' (Beattie and Pratt 2002: 1)

Milne and Chan (1999) examine the usefulness of social disclosures from annual reports for investment decision-making and find that in some situations, the provision of social disclosure may be associated with fund allocation decisions away from the company disclosing social information. In a paper-based test (ie not involving face-to-face interviews), analysts allocated 'on average 7% of their funds away from the firm that provides corporate social disclosure' (Milne and Chan (1999: 450). They conclude that, 'overall, the results from this study suggest corporate narrative social disclosures do not make much difference to investors' decision making' (p. 451) and, 'only when corporate social disclosure [has] a significant impact on future cashflow will it be perceived as useful' (p. 452)

In a similar study analysing the news direction (good or bad news) of social and environmental disclosures, Chan and Milne (1999) note that: 'UK City analysts... are driven by the requirements of their clients, which they interpret to be primarily a positive financial outcome on the clients' investments. Issues considered moral or emotional are not seen as part of the analyst's remit' (Chan and Milne 1999: 266). Deegan and Rankin (1997) find that social, and especially environmental, information is important to some non-institutional investors but, notably, is of little importance to investment analysts.

### **3.4. MATERIALITY OF ENVIRONMENTAL REPORTING (SPECIFICALLY)**

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Whereas many previous studies do not disaggregate the narrative-containing content referring to a range of social and environmental, community, health, safety and ethical issues, a number do seek specifically to examine the effects of environmental narratives on users of annual reports. There are mixed findings on the actual or potential investment materiality of environmental disclosures.

In an industry-specific study, Blacconiere and Patten (1994) analyse whether share prices are systematically affected by environmental disasters. They find that, from a sample of 47 firms, companies with extensive environmental disclosure prior to the Bhopal incident in 1984 experienced a less negative market reaction to the disaster than their counterparts in the chemicals industry who communicated very little about environmental matters. It is this use of environmental disclosure as a part of an organisation's risk management profile that is most often considered to be the most 'useful' use of environmental disclosure as far as analysts are concerned. Studies that have found a link between environmental

issues and value relevance include Hughes (2000) and Lorraine et al. (2004), although the value of environmental disclosures was not always supported in terms of value relevance. But, even then, the evidence is scant that environmental disclosures are material in normal market conditions (ie without the perturbations caused by a Bhopal or an Exxon Valdez).

Deegan and Rankin (1997) find that social and especially environmental information is important to non-institutional investors but of little importance to investment analysts. Deegan and Rankin (1999) report that, 'BiE [Business in the Environment] provided evidence that London based financial analysts considered the environmental performance of corporations to be largely irrelevant in determining the investments to recommend to their clients' (Deegan and Rankin (1999: 326). They continue, 'while 73.3% of shareholders and 75% of accounting academics seek this information, stockbrokers and analysts were significantly less likely to seek environmental information within the annual report than any other group of users' (p. 329).

A study highly relevant to the research described in this report is Thompson and Cowton (2004). They examine the interface between bank lending and demand for environmental information while arguing that there is a strong case for banks to have a particularly acute exposure to environmental issues. The reason for this enhanced exposure, they argue, is, they argue, because of the potential risks a bank could become exposed to as a result of its lending. This argument represents a fundamental challenge to the assumptions made in some studies that banking can be considered a 'clean' rather than a 'dirty' industry because its direct activities have relatively little environmental impact.

Thompson and Cowton (2004) identify three types of environmental risk that might have an impact upon a bank. Direct environmental risk is that arising from liability for the remediation of environmental damage to property it has obtained, perhaps by a loan default or similar. Indirect exposure, which Thompson and Cowton suggest is the most common, arises when a company holding loan capital from the lending bank goes out of business as a result of its own environmental risk, perhaps arising from a lawsuit or the costs of implementing a new environmental standard or similar. The difference, as far as the bank is concerned, between direct and indirect exposure is one of the limits of liability. For direct risk, the potential liability may be greater than the initial loan amount – for indirect risk, the liability is limited to the amount already lent. A third category of risk linked to the environment is more difficult to measure but perhaps the most important – that of derived reputational risk (Buxton 1997).

In summary, this research attempts to address a number of the calls for additional research in this area by engaging with a primary annual report user group. The research provides insights into the relative importance of voluntary disclosures that have been widely used in the underpinning literature, covering, among other things, risk, social and environmental issues, strategy and governance.



## 4. Research questions and method

### 4.1 RESEARCH QUESTIONS

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The research questions raised in this studies, in response to the calls from previous studies, concern the materiality and usefulness of narrative disclosures to sell-side analysts, who are a significant user group of accounting information in the investment supply chain. In particular, it was decided that evidence should be sought on the narratives that have constituted the major part of the academic interest in narrative reporting, which are:

- the chairman's statement and strategy reporting
- risk reporting
- social and environmental disclosure
- corporate governance content
- the importance of narrative reporting generally.

It was helpful, when guiding each discussion with the analysts, to divide the conversation into sections, which meant introducing each 'category' of voluntary disclosure and asking specifically about that. To this end, social and environmental disclosures and governance disclosures were discussed separately with the analysts rather than combining them. This approach is consistent with previous and current literature reflecting two distinct areas of study. While there may be overlaps between the two categories, this could be the same for any of the voluntary disclosure areas, for instance risk and governance. In keeping with the objectives of the research, it was necessary to identify and discuss individual categories of voluntary disclosure and to gather evidence on their usefulness or otherwise to analysts as information users. To combine categories would serve to lose this detail and resolution of opinion.

The chairman's statement is voluntary although universally adopted and there is no mandatory content prescription. Corporate governance disclosure, which has grown in volume substantially in recent years, is required in the UK under the provisions of the relevant corporate governance codes (notably by the contents of the FRC's *Combined Code 2003*) under 'comply or explain'. Risk reporting, social, community and environmental reporting are entirely voluntary, although some companies wishing to comply with voluntary reporting frameworks such as the Global Reporting Initiative (GRI) may include some content to ensure compliance.

A more problematic issue to resolve was the sectoral representation of the analysts in the sample. While a broad sectoral sample would superficially appear to be a desirable quality of the sample, it was preferred instead to concentrate on just one, albeit major, sector for the study. This was for two main reasons.

First, a single sectoral representation would enable intra-industry observations to be made, the reliability of which would increase with repetition by sample members. Second, it would enable the information needs of one

particular cohort of sectoral analysts to be examined in detail, which would not be possible were analysts to be drawn from across a range of sectors. Additionally, with the numbers of London-based sell-side analysts representing the major investment houses in any given sector being relatively low, it was a happy possibility that the sample chosen for interview would approximate to the population, thus providing the maximum possible reliability of findings for that sector, given the number of participating bank analysts in the research. In total 19 sell-side banking analysts were interviewed. As at July 2008, Alliance and Leicester plc listed individual analysts in 18 firms that provided analyst coverage and Barclays plc provided a similar list of 23 firms. All the analysts interviewed for this research were from firms named as providing coverage.

The four major 'volume' areas of analysis in London are technology, pharmaceuticals, oil/gas and banks. For this study, it was decided to focus attention on the analysts of UK banks. This was for two reasons. First, it would facilitate the interrogation of the perspectives and views of a high proportion of the London-based analysts of a strategically important sector for the UK and European economy (see Centre for Economics and Business Research 2007). In terms of market values as at the end of 2007, banks represented approximately 15% of the total FTSE 100 value.<sup>1</sup> Second, there are ample reasons why all the narrative disclosures under consideration in this research could be material and/or useful to investors. The chairman's statement may contain important strategy disclosure; risk reporting may contain risks previously unknown to analysts that are capable of affecting returns, while social and environmental reporting may affect the bank's risk exposure (depending on the environmental risks associated with loans) and the reputation of the bank as a responsible social and environmental 'citizen'. Corporate governance is potentially the most perfunctory of the reporting categories taking into account that compliance with the *Combined Code* can be considered a 'box-ticking' exercise.

### 4.2 METHOD

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It was necessary to gain access to a number of analysts so as to establish their views on the subjects of the research questions. In order to identify a cohort of analysts to approach, the list of analysts that covered Alliance & Leicester plc was used as a starting point (the list was, happily, available on the Alliance & Leicester website). On contacting the analysts on the list by telephone, it became clear that most also covered other UK high street retail banks and it emerged that the list was a fair approximation to the population of UK bank analysts in the City of London.

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1. Based on banks' collective valuation of £212 billion against a FTSE 100 value of £1,472 billion.

On having the nature of the project briefly explained to them over the phone, all but one of the analysts on the list agreed to be interviewed. The interviews took place at the London office of each analyst between the autumn of 2004 and the summer of 2006. Once a small number of analysts had been removed from consideration for reasons of non-availability (such as retirement, career moves, etc.), the number of possible suitable analysts was 20. Allowing for the one refusal, the final number of analysts interviewed for the project was 19. Each analyst was interviewed by one or both of the two researchers conducting the study.

At the start of each interview, the analyst was initially assured that his or her evidence would be fully anonymised and accordingly, they could speak freely on their views about the matters in question. After that, a recent annual report of a bank covered by the analyst was produced by the interviewer and the analyst was invited to describe how they would use the document if that was the first time they had seen it.

The Alliance & Leicester plc annual report and accounts for year end 2003 was used for this purpose. This was for two reasons. First, it contained examples of all of the categories of narrative disclosure being studied and second, it was manageable in size in comparison with some of the other, substantially more voluminous tomes that are produced by some banks (notably by HSBC).

The analysts spoke uninterrupted for as long as they wanted in response to the first request. Following that, a number of follow-up questions were asked to establish each analyst's views on the usefulness, and more specifically on the materiality, of each disclosure category and of narrative reporting in general to them as analysts. In this respect, each encounter was similar to a semi-structured interview in terms of research method. A standard list of questions was asked, clarifications were sought and occasional tangential diversions were indulged in. Each encounter was good-natured and cordial containing both informal and semi-formal exchanges. All interviews were recorded in their entirety and subsequently transcribed. A typical encounter lasted a total of one hour.

## 5. Evidence from analysts

### 5.1 THE COHORT AND GENERAL PERCEPTIONS OF THE ANNUAL REPORT

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The cohort of analysts interviewed for this research had an average of 8.5 years' experience in the job. The majority were not professionally qualified in accounting although all were qualified to degree level or higher. The most common academic backgrounds of interviewees were (in order) economics, maths, finance, accounting and law.

Almost all the analysts interviewed discussed the limitations of the annual report in terms of the timing of its publication. While the year-end results are accompanied by the preliminary accounts ('prelims', which include narrative contents), the final printed version of the annual report and accounts is often not published until some weeks later, by which time the information in the prelims has formed the basis of the analysts' forecasts. This publication lag significantly reduces the usefulness of the final document as an investment-material source of information. The detail in the preliminaries and the information conveyed by management at the results presentation are far more important in the intervening period.

Analyst A2 noted:

*On the basis that you get your report and accounts after you've already had the preliminary results, you are two months down the line from when you were actually given the specific... information in the preliminary results*

Analyst A5 stated bluntly:

*Well I wouldn't use that document [the annual report] to start with because... the results typically come out in February and this is published in April. So is it a major event? No.*

Analyst A16:

*From my point of view the annual report rarely gets used in the way I've just described ... to you [which was a detailed illustration of how each section could be technically used]. To me it's more a way of getting hard detail and you know by the time it's out it's been fully audited and there's no way that they're going to revise anything.*

Most, however, took a less strident view than this, with the majority referring to the document variously as potentially important for new information that is most likely to be in the detail and possibly in the notes to the accounts. In this regard, it is used as a historical document that contains more detail than the preliminaries.

Analyst A5 went on to say:

*Now where the annual report comes in far more useful is where, for instance, you say, have Barclays or Royal Bank of Scotland. The companies... don't publish their annual report on the actual day. You therefore go back to it ... to*

*look through things in a lot more detail in terms of that kind of information.*

Despite the limitations caused by the publication lag, the contents of the annual report in general were considered by most to be potentially highly material to the investment decision, although the cohort differed substantially in the use they made of the document.

Analyst A12's remark was typical:

*I would say it's highly material. As an analyst there are two opportunities each year to really understand how a company's doing. One is the interim results; one is the final results. And most of our forecast revision, most of our recommendation changes I think are driven by what management say at either or both of the results presentations. I would place a high reliance on the annual report. The model which drives our recommendations is basically the annual report but extrapolated, so it's crucial to the model. So I place a high reliance on it and would say it's a very important document indeed.*

Analyst A14's criticism was less to do with the publication timing and rather more to do with their increased length and complexity. Commenting especially on HSBC's weighty annual report, Analyst A14 remarked:

*To be honest the annual report bit would probably score pretty lowly [in terms of usefulness to me]: a 1 or a 2 [out of 10]. I've given up on how many times I've got [this sort of] message back from HSBC in response to my question: 'If you go to the US disclosure no. 4, page 232 then you'll find the answer to your question'. Great, fine, but actually I'm still going to continue to email you even if all you do is give me the reference of where it is, because I'm not going to read... there's just way too much to read.*

Analyst A16 also commented on the increased length not necessarily being helpful.

*This is where banks sometimes get a bit confused because you ask for better disclosure and they think 'oh, look, we've given you 600 pages already' [which contains] 575 pages of completely worthless guff. What we really want is granularity and in the areas that matter.*

### 5.2 USE OF FINANCIAL INFORMATION

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One of the prominent emphases made by all the analysts in the sample was the overwhelming importance placed upon the numerical financial data in annual reports. This was not a surprising finding insofar as one of the main roles of an analyst is to forecast the key financial statistics over the forthcoming period, and the recent history of those statistics is therefore of utmost interest.

The initial part of each meeting with the analysts was spent asking each interviewee to talk through, in their own words and in their own time, how they would begin to consume the information in the annual report if that had been the first time they had seen that document. This

enabled each analyst to highlight what was, to him or her, the section of most material immediate interest. It came as no surprise that each analyst went straight to the financials.

The order varied among the cohort, but in almost all cases, the first 'port of call' was either the income statement or the notes to the accounts. The balance sheet was considered less important in most situations than the income statement and the cash flow statement was generally viewed as less material again. Analyst A1 reported that, 'To be honest as bank analysts we don't tend to look at the cash flow statement too much.' Segmental disclosure was, however, highly valued.

The relative importance of the income statement for earnings and costs forecasts was emphasised by most of the cohort. Analyst A16 was relatively dismissive of the balance sheet in comparison.

*I don't spend a lot of time digging through the balance sheet. I certainly don't try and forecast the balance sheet on a line-by-line basis [as I do with the income statement].*

Analyst A14 was typical in describing the general approach taken.

*My normal first port of call is to go into the notes to the accounts because this is the additional disclosure to the prelims... and in particular I'm interested in the balance sheet at the consolidated level and the cash flow at the consolidated level and therefore I would go through the notes to the accounts.*

Similarly, Analyst A7 remarked as follows.

*P & L accounts, the balance sheet, the notes and in particular the financial review which obviously gives some sort of qualitative discussion around the numbers to at least give some sort of context and explanations in terms of why particular numbers in the accounts and the income statement, etc. have moved in the way in which they do.*

A15 explained the purpose of the financial analysis as trying to get 'a feel for the underlying situation of the company and even then you'll find that some of the numbers we probably will disregard. We will have our own way of calculating [financial statistics]'.

There was a general scepticism about reported figures among most of the cohort. Financial ratios given by the reporting company were never taken at 'face value' and other figures were frequently added back to reported costs and earnings to arrive at what the analysts considered a more reliable figure. Analyst A16, for example, referred to having to 'dig deeper to strip out any of the one-off effects or to get a feel for what the trends are'.

### 5.3 VIEWS ON THE 'FRONT END' AND GENERAL NARRATIVE REPORTING IN THE ANNUAL REPORT

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It was when discussing the annual report content other than the financials that differences of opinion between analysts began to become evident. This is the section of the annual report that has seen the most growth over recent years, as companies have included more and more information on various aspects of their business apart from the purely financial. In this context, 'front end' includes the collective disclosures that take narrative rather than numerical form. Asking each analyst their view on this was intended to gain evidence of their overall views on the importance of narrative reporting in general. In most cases, the 'front end' includes the chairman's statement, possibly a chief executive's review, an operating review, corporate governance disclosure, risk disclosure, health, safety, social and environmental disclosure, and various other narratives that companies include on an ad hoc basis.

This section of the annual report would theoretically be of interest when the information sought is not available in – or cannot be expressed by – the financial information. In practice, much of what is in the narrative sections is content already seen in the preliminaries so it suffers from the same time lag limitation as other content of the annual report as a whole.

Opinions on the materiality and usefulness of 'front end' narrative reporting were mixed in the cohort of analysts.

Analyst A2 spoke for the majority in viewing the contents of the 'front end' as template driven.

*You almost can get slightly cynical about the questions of box-ticking by executives and what the reasons are for doing that. I would guess that generally, in terms of reporting and information provided, they tend to stick together as a pack [meaning the categories they disclose are very similar].*

Analyst A13 expressed a similar view.

*But in terms of the sections which are solid text in terms of, say, 'our policy' as regards the environment or our employees or our shareholders – most of that tends to be template-driven stuff.*

Analyst A9 said that the narrative form of the 'front end' was one of the reasons for its not being widely used by analysts.

*There are things that need to be here and maybe once every three years you might [read it] because you have a specific issue and you go here [to find something out]. If I get this report would I look at it in great detail? No. But where we come from we are much more about numbers – I want to see the numbers.*

Analyst A15 suggested that there may be an audience issue with the materiality of 'front end' narrative reporting,

referring to the information needs of independent shareholders (not dealing through fund managers) and the specific information needs of analysts.

*If you are looking at it as an independent shareholder you will concentrate, as I say, on the first 30 pages of the blurb. As an analyst, given that we probably know all of that...the first 30 pages will probably never get read.*

Interviewer: 'So front end voluntary? Not interested?'

*Completely not interested. I could probably say that I have not read any of those.*

Analyst A10 expressed a similar view, saying, 'it is exceptionally rare that I'd actually look at anything in the front pages', while Analyst A14 saw most of the 'front end' as something that might be perused briefly but then kept as a source of information:

*The director's report largely is a skip-through. As I say it's not something I would go to and read specifically first but its good to have it there as a reference.*

Analyst A4 was critical of the perfunctory and redundant nature of some of the narrative contents.

*There's a lot of rubbish actually that could have been in there [the Alliance & Leicester annual report] but wasn't. HSBC are swines for bulking the whole thing out [with less than useful content].*

Analyst A8 was critical of the narrative content of the reports because of potential issues that could arise owing not only to undisclosed management motives but also to audit requirements.

*Those [narrative sections] are read with a sceptical eye because companies rarely admit when things are going wrong until they've gone so badly wrong that the management who'd got them wrong have been fired and the new guys come in and [say] 'oh that was a terrible idea'. But yes, of course, a lot of the feel for what's going on in the business is up front, not down the back [of the report] but as we discussed, the segmental reports are unaudited so they're at the front not the back generally.*

Analyst A8 went on to describe some of the concerns with narrative reporting generally.

*I would say companies consistently strive to position themselves in a favourable light, so that you have discretion to describe things as you see them and to put more emphasis on the things that are going well than the things that are going less well. So [while]... I would absolutely not... accuse the companies of lying, I would accuse the companies of indulging in self-promotion.*

Despite these misgivings, however, the consensus overall view was that the 'front end' was capable of containing content of material use to analysts. Analyst A17 gave an example of this.

*But what we look for in there is any statement about the outlook and any statement about management or on targets. That is actually very important.*

The importance of strategy content in the annual report is discussed in the next section.

#### 5.4 CHAIRMAN'S STATEMENT AND STRATEGY DISCLOSURE

The chairman's statement is one of the most-discussed and researched elements of the annual report 'front end' in the literature. It has been analysed in terms of readability, bias and news direction (see in the discussion of the literature above). There is neither prescription in company law nor listing rules about the content of the chairman's statement. In practice, chairmen have typically used the statement (or 'letter') as a vehicle for summarising the previous year's performance, to highlight any key changes, to acknowledge those who have contributed to any successes and to comment on 'going concern' and future prospect issues over the subsequent year.

Analyst A13 summarised the importance of the chairman's statement in the annual report.

*Well, I think he [the chairman] has a moral duty... to communicate with shareholders, to put his name to the annual report and say 'this is mine' and 'I'm upfront and this is how I'm leading the organisation'. The second reason would be that they will have a significant number of shareholders whose only substantive communication with the company will be this [document, the annual report] every year: people who own the stock on their own account and who are not sophisticated followers of the market.*

While the majority of the cohort of analysts made comments similar to those of Analyst A13, there was a considerable and prevailing expression of scepticism over the value of the content. The most oft-cited reason for this scepticism was the lack of strategy content and, for this reason, most analysts compared the chairman's statement unfavourably with the usually more detailed chief executive's review.

In the quest for greater detail and granularity, most of the analysts were dismissive of the chairman's statement as less than material, with some reserving some relatively unmeasured language for it.

Analyst A3 began by commenting that the chairman's statement was 'bloody irrelevant' before proceeding to clarify this remark by citing the sections of a typical chairman's statement.

*Well the chairman's statement tends not to [contain strategy] does it? 'Economic outlook', well, thank you I've got a fair idea myself. 'Results' I can read. 'Capital and dividend' I know you're double A-rated or whatever. 'Our people', 'Board changes', 'Realising our potential': yes. I*



*suppose 'Realising our potential' could have been interesting [but wasn't].*

Analyst A13 provided a helpful summary of the way in which most analysts view the chairman's statement.

*Well, we certainly read it but I've yet to read one that tells us anything that we either weren't told at an analysts' meeting two months before the financials came out or that isn't part of a communicated strategy that's been around for ages. So you look at the two pages that we have here from the chairman: 'Economic outlook' – we have economists that do that; 'Results of the company' would have been enunciated at their meeting and we would know all about that; 'Capital and dividend' is extraordinarily important for [a bank] and so we would have a look at that but again because it's so important. Typically the wording we won't have seen before – that would be the most important component of that. 'Our people are valued' [and] 'Board changes', again, tend not to be all that material particularly when it's on the non-executive side of things. 'Realising our potential', you know, I hope they do!*

Analyst A13 said that the chairman's statement 'isn't the place where you're going to see a change in policy or a change in strategy.' Analyst A9 said it was 'too woolly; it doesn't tell you much'. Analyst A7 spoke for the majority, referring to its potential materiality as 'limited', while Analyst A15 preferred the term 'useless'. Similarly, Analyst A4 remarked, 'nine times out of ten [the chairman's statement] would be useless' with similar disdain by Analyst A5, who simply said, 'I tend not to focus on this as an analyst'. Analyst A14, perhaps with a little overstatement for effect said, 'I don't think that I've ever read one'. Another direct criticism was made by Analyst A16 who said, 'I find [it] usually not that helpful... I tend not to focus hugely on the chairman's statement.' When, in conclusion, Analyst A12 was asked, 'So is the chairman's statement immaterial for the most part?', the reply was, 'I think so, yes'. Analyst A4 concluded that the chairman's statement was 'worthless as far as I'm concerned'.

The most usual reason for the dismissal of the chairman's statement as a material and useful disclosure was its lack of detail and its cursory treatment of information on the company's strategy. For this reason, some analysts compared it unfavourably with the often more useful (and, in contrast to the chairman's statement, voluntary) chief executive's review. The fact that this particular piece of voluntary narrative has effectively become a fixture of the annual report, typically under an 'operating and financial review' section or similar, was greatly welcomed.

Analyst A12 remarked, 'The chairman's statement I'd sort of regard as a slightly watered down version of the CE's statement,' while Analyst A16 commented, 'what the chief executive says is definitely more interesting and more relevant to me'. Analyst A3's comment was based on the Alliance & Leicester plc 2003 accounts that were used as a basis for the discussion:

*The strategy bit of the chairman's statement is like those five column inches. You turn over to what [the CEO] is saying [which includes] 'management priorities, managing the portfolio, maintaining building, profitability, position...' I mean you've got a full two pages overleaf from the CEO.*

Analyst A4 highlighted the typical content of the chief executive's report in explaining its usefulness:

*Chief Executive's review – more interesting [than the chairman's statement]. [I] wouldn't necessarily read that first but probably would try and read it, not least because that usually is where you get them admitting to missing targets or saying what targets they've made and that's where you get targets for the future.*

A similar remark was made by Analyst A18: '[The chief executive's statement] usually has a brief summary of what's happened in the year past and any big events that they expect for the next year.'

## 5.5 RISK DISCLOSURE

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Risk disclosure and risk management information are two of the most notable additions to the voluntary content of annual reports since the mid-1990s. Whereas previously, company officers might have made reference, in an unsystematic manner, to risks as part of their overall discussion, the segregation of risk information into a dedicated section is a relatively recent innovation. The banks' reports that were discussed during conversations with the analysts were typical of other annual reports in containing a separate page or more of narrative reporting on this subject.

In almost all cases, risk reporting in the 'front end' of the annual report is entirely narrative in nature, and numbers, where relevant, are confined to the notes to the accounts. In the Alliance & Leicester accounts that were used as the basis for discussion, the risk reporting comprised narrative sections on operational risk, credit risk, market risk, interest rate risk, foreign exchange risk, equity risk, liquidity risk and derivatives. Each section contained a definition of the type of risk in question and this was usually followed by an indication of company policy in respect of the risk and typical actions taken to gather intelligence on it. The discussion of operational risk in the Alliance and Leicester accounts, for example, contained three paragraphs that respectively began: 'Operational risk is defined as...', 'The Group monitors its operational risk through a variety of techniques...' and 'Operational risk is managed through a combination of internal controls...'

While recognising that this narrative tends to be template driven, the analysts expressed a range of opinions on this particular category of narrative reporting. Although, *prima facie*, risk disclosure might be considered to be naturally material in the banking sector, the majority of analysts expressed scepticism about narrative risk reporting in the annual report. A typical opinion was that risk reporting was simply a boiler-plating or a box-ticking exercise

performed annually by companies without any real attempt to report either on the actual changes in risk exposure over the year or as anticipated in the year ahead. Most of the analysts relied on their own sector-relevant knowledge of banking risks and risk management, and viewed disclosure as being, for the most part, meaningless to them. Moreover, the levels of disclosure were often regarded as being too simplistic for analysts on the one hand but perhaps too complex for the individual non-specialist investor on the other. In this respect, it was suggested that risk reporting failed as a material disclosure for both types of annual report user. Analyst A5 pointed to the pro forma-driven content and suggested that, 'if I as an analyst didn't know what the risks were in a bank I wouldn't be employed by the bank I work for.'

Referring to the risk narrative, Analyst A5 continued, 'that's generic what's written there, and it's probably not even a very good description of [risk] to someone who didn't really understand [such as an independent investor]. Does it really tell you anything? No.' One possible reason for the limitations of risk narrative content was suggested by Analyst A18 who said, 'the risk section... should be more interesting but it usually tends not to be because they never give anything away and that is the problem'. Analyst A11 remarked that, 'a lot of it is stating the obvious a lot of the time' and Analyst A12 opined, 'I think it's mostly common sense'.

Frustration with the shallow and perfunctory nature of risk content was raised by several analysts. Analyst A4 made a general criticism:

*then we are immediately into risk management and control, which is almost always useless. So we've got pages on foreign exchange rates, tax derivatives and uses. Realistically there is nothing that you can say from the outside about how someone else's treasury is working. This stuff is just completely useless.*

Analyst A3:

*For people who are risk management fetishists, I'm sure it's good to have and in terms of ticking boxes [and] it seems to be a useful exercise. This must be infuriating for the banks having to do [this] because they'll probably sit there, roll their eyes and scribble down whatever fits the relevant boxes.*

Analyst A7:

*Risk management and control, which is probably 2, 3, 4 pages worth of how they deal with and manage equity response, exchange risk, interest rate risk. [My criticisms are]: a) it doesn't tend to change very much from year to year, [and] b), frankly most of this stuff is pretty common from bank to bank. Once you've read it once, you've probably read it as many times as you want to and it does very much tend to have this sense of being boiler-plating.*

Analyst A17:

*They just copy them from year to year so when they do the accounts they say 'oh we have to put in this' and they take last year's and just put them, in which means we've already read them [in last year's accounts].*

Analyst A3 hinted that one reason for the poverty of disclosure was the complexity of the banking business.

*If you want a decent discussion of risk management within banks you kind of need to be a banker already to understand it because they are inherently very complicated businesses.*

There was, nevertheless, a general feeling that the presence of risk narrative was a potential source of comfort to analysts even though the content was probably not of direct material interest. Analyst A11 was typical in expressing the view: 'I think it's important to have it in because I think it makes banks think about those risks'. And similarly, Analyst A16 remarked that, 'the fact that it's there – you see it's there, you know it's there – it gives you some comfort that somebody has thought about it'.

When the question of reading the actual risk narrative reporting was raised, however, the general view was that analysts did not read it. Analyst A14 struck a sceptical note, saying, 'I don't think I've ever read much on operational risk but I certainly never remember reading anything useful in there.' Analyst A4 described the content as being of 'little use' and Analyst A16, on being asked whether he or she ever read the risk reporting narrative, commented, 'Probably not to be honest; probably not'.

A potential use of risk reporting was suggested by Analyst A4 in expressing frustration with dealing with investor relations (IR) people in some banks.

*What I would like to see – and I've seen it absolutely nowhere – is you always have to drag these statements out of the IR people and its always like pulling teeth to get them to say something. Simple things like: do you hedge the following foreign exchange risk [example of foreign exchange risk given]?*

Finally, only one analyst (Analyst A1) in the cohort of 19 expressed something approximating to a positive view of the current state of risk reporting.

Interviewer: 'Do you look at risk disclosure?'

*Yes. The risk section is a key section in terms of country exposure, sector exposure and... trading risk as well. Those are all in there... and the risk management and control [and] operating risk [are items] that, yes, you'd look through.*

## 5.6 CORPORATE GOVERNANCE DISCLOSURE

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Disclosure on corporate governance issues has been in the ascendant since the early 1990s when these issues first became of concern in the light of the *Cadbury Report* (1992) and since. The manner in which corporate governance content has been presented has become increasingly complex and organised in recent years as companies have sought to comply both with the range of (legally) voluntary codes and increased market expectations. Codes of practice in corporate governance have included those on executive remuneration, non-executive directors, committee structures, internal control and reporting. In each case, the codes provide for the disclosure of information pertaining to that area in the annual report.

In the UK, corporate governance code compliance is voluntary in law but effectively mandatory under stock market listing rules (this being the nature of control in a principles-based jurisdiction). Although technically, companies can 'comply or explain', in practice large companies, and perhaps especially banks, normally comply to a high degree to maximise market confidence. One of the results of the increasing number of corporate governance codes since 1991 has been a substantial volumetric increase in corporate governance reporting. In contrast to some other sections of 'front end' reporting, corporate governance reporting is often numerical in part (reporting on executive salaries, for example) and its content is effectively prescribed by the various contents of the various codes of practice.

One reason why corporate governance in the banking sector has been a matter of historical concern to stock market participants was the collapse of a bank (the Bank of Credit and Commerce International – BCCI) in 1991, which was one of the causes of increased regulation. Analyst A2 drew attention to this, saying:

*there have been banking disasters, [such as] BCCI, but I guess I'm starting [these days] with an implicit or assumed confidence [in banks' corporate governance]. It might be misplaced but there have been one or two cases.*

Analyst A12, similarly, opined, 'I think corporate governance is an important issue. We've had scandals in the bank sector that proved it is important.' This research was undertaken before concerns about Northern Rock emerged in the autumn of 2007.

The evidence from the cohort of analysts was that the increased corporate governance requirements including and since Cadbury had served to increase confidence in governance systems. Analyst A3's confidence was signified by the comment, 'corporate governance? Don't care that much in the UK'. Analyst A6 said that, 'it [corporate governance] doesn't tend to be an issue in the UK' and Analyst A12 stated bluntly, 'I have confidence in the banks' corporate governance structures'. Analyst A2 spoke for the

majority saying, 'I'm not aware of that many cases of major corporate governance problems with a bank'. When Analyst A13 was asked: 'so you have full confidence in the corporate governance in UK banking?' the reply was, 'In so far as it's important, yes'.

Several analysts brought out the confidence of corporate governance in UK-based banks. Because most of the cohort covered only these banks, they were not able to comment on corporate governance in other jurisdictions with lesser governance provisions. Analyst A6 said that:

*because we cover UK and Irish banks and it's certainly less relevant from our point of view. But yes, I think undeniably it obviously becomes important where corporate governance might be an issue [such as in some other jurisdictions].*

With regard to reporting, the prevailing view was that while the presence of corporate governance content was important, it was of little materiality or use to the cohort of analysts. Analyst A7 said:

*it's of very limited interest to me to be absolutely honest. There's very little here that I would actually tend to use... the statement of corporate governance is usually fairly low-value.*

Analyst A6 was more laconic: 'Do I use it? No. Do I think it is important for it to be there? Yes'.

Others expressed blunter opinions, saying that they didn't read the corporate governance content at all. Analyst A7 said, 'I don't tend to look at that at all'. Analyst A12 gave more detail, saying:

*I do not read the corporate governance disclosures. I take the assumption that these companies are FTSE 100 companies, they're going to have pretty much the systems that they need and I'm happy to rely on that assumption.*

Analyst A15 was in a minority, expressing the view that the statement of corporate governance was 'useless'.

## 5.7 SOCIAL AND ENVIRONMENTAL (SE) DISCLOSURE

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While the subject of social, environmental and ethical reporting has increasingly been of interest to academic researchers, there has been relatively infrequent interrogation of user cohorts as to its usefulness and materiality. The evidence offered by the analysts in this study suggests a range of responses to this reporting category, but the prevailing belief is that both social and environmental matters are of limited interest to the professional analyst and forecaster. Probing the reasons for this lack of interest was one of the most intriguing parts of this research project. In organising the evidence in this disclosure category, content is set out in five subsections:



- whether SE narrative is used and its materiality
- evidence that some analysts may misunderstand the nature of SE narrative
- environmental risk and disclosure
- the potential (rather than the current) materiality of SE reporting, and
- the way in which SE reporting is seen in the context of the whole annual report.

### Use made, and materiality of, SE narrative reporting

Analyst A2 put the issue in some kind of context, saying:

*as I say banks, although they do have a part in the social fabric and so on... – the whole kind of stakeholder idea – for what I'm trying to do [social and environmental reporting is] not that relevant really.*

Analyst A15, as part of a commentary on his or her use of annual report contents said, 'corporate social responsibility report? Even more useless [than the chairman's statement and corporate governance].' Analyst A17 said, 'it sounds bad but from our point of view at the moment this CSR/ environmental [disclosure] is close to useless.'

Analyst A14 expressed this view: 'Corporate and social responsibility report? Forget it. Just forget it' after which the interviewer pressed, 'Is CSR reporting totally useless to you?' 'Yes!'

Upon probing in a little depth, it became apparent that social and environmental reporting was, for the cohort of analysts, perhaps the least read and least relevant part of the entire annual report. Analyst A1 was asked 'Are you interested in social and environmental disclosure at all?' which received the reply, 'Not really, no.' Analyst A2 said, 'Frankly I'd ignore it really' and Analyst A4 said that 'Corporate and social [disclosure was] definitely no use.' Analyst A7 reported that it was 'absolutely useless from my point of view'.

Analyst A4 continued with a commentary.

*Business ethics [quoting from the narrative] blah blah blah. I'm not being funny but it just would never occur to me to look at that. There might be something incredibly useful in here but I would bet money that there isn't! [So] corporate social [disclosure is] definitely no use. I've been a analyst now for eight years and it has come up in conversation exactly once during that time.*

Analyst A1 confessed that:

*I've never really looked at one [a social and environmental report] before so I could be just alone [in my view, but] we've got so many pressures on our time that it's quite low in our list of priorities to actually read through that and if you've got to read the whole report that's going to be the last [thing you would read].*

Analyst A6 claimed to read the social and environmental report, 'very, very rarely... actually I don't think I've ever read through one'. Analyst A10 said of social and environmental reporting, 'don't give a damn. Personally I might give a damn. Professionally I don't care.' Analyst A11 said, 'very laudable but I'm not interested', Analyst A13's view was that 'speaking purely from an investment analyst perspective it's not useful at all', and Analyst A12 said 'I don't read that part of the account.' Similarly, Analyst A16 said: 'I can't see any value in that section. I've probably never read one'.

Specifically with regard to environmental disclosure, Analyst A4 was as dismissive as he or she had been for the rest of the business ethics reporting (in the annual report being discussed): 'Environmental blah blah blah. It's a bank,' implying that this identity had a bearing on its interest in environmental matters. Analyst A13 said that environmental narrative was 'even less useful' than the social and ethical components. Analyst A14's view was: 'I think... it's a waste of money to be printing a lot of this, and also, I suppose there's a kind of irony in printing an environmental report that nobody reads'.

With specific regard to social and environmental narrative and the question of materiality, the consensus view was that it was perhaps the least material (actual or potential) component of the annual report. There were, according to the cohort, a small number of situations in which it could be material to investment decisions but these were considered to be marginal: analysing for socially responsible funds or when a specific environmental risk applies. Analyst A6 reported that, 'if the client's funds aren't socially responsible... then this sort of stuff is obviously somewhat less relevant to an extent from that [materiality] point of view'.

Analyst A5 was asked: 'So in terms of your work as an analyst how you would judge the CSR component [of the annual report]?'

*Not material at all. There might be analysts out there who sit and read this from cover to cover but is there anything in here material that's going to affect the share price? No.*

Analyst A9 highlighted a limitation of all narrative reporting, to analysts, with specific reference to social and environmental content, saying that, 'These are more soft issues and they wouldn't be driving the [forecasting] model. We are about numbers. We are putting numbers in a spreadsheet and coming up with a forecast.' The implication of this comment is that unlike some other narratives, social and environmental reporting is unlikely to contain information capable of amending or informing any aspect of the financial forecasting model. In this respect, it seems there is a weak belief that any important environmental risks would be discussed in the social and environmental narrative.

Analyst A12 expanded on this belief.

*I know that there is an increasing demand in the market for ethical investment and those sorts of disclosures can help convince people of the ethics of investing in companies but we're really interested in financial performance and valuation. I'm not convinced that at the moment those sorts of considerations [such as] CSR disclosures drive share prices.*

Analyst A18 expressed a similar view.

*I wouldn't say they were completely useless but nothing from those sections go[es] into our models on how the companies work. We never write about that section at all.*

### **Misunderstanding of SE reporting**

A small amount of evidence emerged that analysts, in their unwillingness (in some cases) to read the social and environmental section of an annual report, may have misunderstood its content. Whereas in fact many reporting organisations, including banks, report on the environmental impact of their activities, some analysts appeared to judge social and environmental reporting on its most perfunctory content.

Analyst A4, for example, was dismissive, saying:

*Looking at it, it's just sort of 'for customers who are deaf, hard of hearing or have speech impediments, a fully qualified sign language interpreter is available on request'.*

Analyst A14 was seemingly unaware of the more detailed content of social and environmental reporting that has been introduced in recent years.

*I don't think that corporate social responsibility has any bearing on socially responsible investor issues because it's all about how much paper – well I'm guessing because I haven't read one – but I'm guessing it's all about how much paper they've used and all this kind of stuff. Terribly irrelevant.*

### **Environmental disclosure and secondary environmental risk**

One of the particular issues that the researchers wanted to explore with the cohort was the importance placed on a bank's environmental exposure through its loan book rather than through its direct operations. For the purposes of clarity, direct environmental impact is defined as that applying to the actual operation of the organisation's main direct operations. For a bank, this would be the environmental impact of its own employees in the normal pursuit of activities.

The point raised by Thompson and Cowton (2004), however, was that, uniquely, banks had a potentially large secondary or indirect environmental footprint in the activities that are facilitated or enabled through loans made. Analyst A3 was asked about the general

environmental risks for a bank. The answer was typical of those failing to recognise indirect environmental risk.

Interviewer: You wouldn't see environmental risk as part of the risk of the business at all?

*Not really in a bank. Certainly if it was like a nuclear power station or an oil company I might worry about it a bit more.*

Analyst A9 gave a blunt answer to the question of whether he or she would ever consider that banks might be complicit in pollution or expose themselves to environmental risks by their lending decisions, saying, 'No. Straightforward answer. No.'

Analyst A3 explained that:

*I think these guys are bankers not some sort of environmental guardians. That is probably something that's far better controlled by other parties. I think it would be harsh of banks to try and work it [secondary environmental impact] out because when I think about investing in a bank I'm thinking about how it's going to create money using my money.*

Analyst A17 expressed similar misgivings, saying:

*If banks by their lending can be held accountable for what the company does with the loan that would make it close to impossible for banks to do anything. The environmental impact, just doing the actual report they would have to use half an entire rain forest just to publish the report.*

Analyst A18's view was that it was not a bank's purpose to moderate lending activity using environmental criteria.

*I think to be honest that is the government's job to regulate what industry does and I think ultimately the management of any company should try and maximise shareholder value.*

Analyst A13 was asked whether he or she could ever envisage a situation where the environmental exposure from the loan book would ever be material to an analyst's forecasts: 'From my perspective, and certainly given the tasks I have, I can't imagine it ever being material.'

### **Potential materiality of SE disclosure**

Given the responses from the cohort on the current relevance and materiality of social and environmental narratives, follow-up questions were asked on the situations that may increase their materiality in the future. The only situation at present where SE disclosure would be an annual report item worth analysing would be if it were for a socially or ethically filtered investment fund.

The size of the change needed was highlighted by Analyst A3, who was asked: 'Could you ever see a situation where an environmental disclosure or a community disclosure would ever be material disclosure for you as an analyst?'

*Yes I could. It would purely be if it was driven by my clients – if we end up with a huge socially responsible investment community that dominates the landscape. At the moment the sort of people, like you and I, [who] invest in our pensions [want] to have a safe retirement, it may be nice to think about the environment a bit on the side, but I don't like to inlay that decision into my pension pot.*

Analyst A6 expressed a similar view:

*I think yes, there are a few situations [where it could be potentially material]. One is the emergence of SRI [socially responsible investment] type funds and if they became – this isn't our drive to, its not us saying you should be socially responsible or not – if the clients say that they want to run socially responsible funds then we would have to react to that. It's their decision to make and if there was a big drive into socially responsible funds then it would become an increasingly important component of the accounts and what the banks are doing.*

Analyst A12 expressed two viewpoints, beginning with the observation that, 'Well the way things are going ethical investing is really taking off'. He or she continued,

*That's a growing phenomenon so there are people in the market that are focusing on these things and if interest in those sorts of issues carries on growing at the rate that it has been then yes I can, in the future, conceive of a time when these sorts of things will be material.*

In concluding, however, Analyst A12 said, 'but we're actually a long way off from that now'.

Analyst A1 was asked if he or she could envisage SE disclosure becoming a material disclosure in the future: 'Only if you're running that type of [SRI] fund. Otherwise no, not really.'

The interviewer proceeded to ask Analyst A1, 'So it would need some kind of paradigmatic shift across the whole of the sector for you to be interested in that?' Analyst A1 replied: 'Yes I think so, yes. I'd be interested to see what other people say about that actually. I'm thinking maybe I'm alone.'

#### **Least material part of an annual report**

Given the general scepticism of the value of the SE narrative in banks' annual reports each analyst was invited to nominate a section that was the 'least material' to him or her in the conduct of their jobs as analysts.

Analyst A1 spoke for the majority, saying, 'for me as an analyst it would probably be the environmental report'. With a note of sarcasm, Analyst A11 said, 'I'll shock you by saying the corporate social responsibility report'.

Some analysts discussed a situation in which the SE content was not present in the annual report at all. Analyst

A14 said: 'No I wouldn't miss it. It would greatly facilitate my reading of the rest of it because it wouldn't be in the way,' and continued to note that it was a section that, 'nobody reads'. Analyst A16 said that: 'It will sound awful but it wouldn't affect me if you lost the whole corporate responsibility section really'.

#### **5.8 'FRONT END' NARRATIVE AS PSYCHOLOGICAL COMFORT**

A number of interesting comments were made by analysts in response to an experiment conducted as a part of the interview process, involving the presentation of an annual report with the narrative front end removed from the document. Given that the prevailing view about most of the front end sections was sceptical in terms of value or materiality, the experiment was intended to test the response of analysts to the notional situation where all the developments in narrative reporting were reversed back to a 'technical-only' situation, where the document opened at the auditor's report.

In terms of content that would be missed by analysts by this reversal, the most cited was the divisional or segmental data most frequently disclosed in the operating and financial review (OFR) (or section of similar name). Analyst A1 remarked that, 'you'd miss the divisional... and I'd miss the financial review.' Analyst A5 asked:

*Where's the divisional disclosure [in this notional document]? There is no divisional disclosure. Analysts have pushed incredibly hard over a number of years to get divisional disclosure and people have had to work hard to do it.*

Analyst A7 referred to some of the technical content contained in the OFR:

*Things like the additional levels of granularity they give you on things like how they calculate their interest margins, which happens to be one of the key assumptions that we use, in terms of trying to predict the future [would be lost in this notional document].*

Analyst A11 said of the annual report without narrative content:

*I think I would have lost a significant amount. I would miss the OFR and [expressing a minority view] I would miss the chairman's statement.*

Opinions were divided over the extent to which, excepting some technical content in the OFR, the narrative content of the annual report would be a serious and material omission as far as the analysts were concerned.

Analyst A1 said that, 'it wouldn't particularly upset me [if the narrative content wasn't there]' but when later asked if it was a comforting pillow to have, answered, 'yes.' Analyst A6 remarked: 'I'm comforted that it's there, yes, definitely. But do I ever use it? Very, very rarely.'

A15 explained the potential effects of the omission of narrative content in a little more detail.

*Yes, my point is that I think if the front end of the accounts weren't there, despite having a lot of negative things to say about them, I think psychologically it would be a very striking omission in the sense that if there is something that you want to double-check, something that the chairman said or something that the directors are going on about, strategy or whatever it is, it's almost a convenience to have it there for somebody to refer to. [So] I like to know that it is there, yes.*

Analyst A16, similarly, expressed the view that despite the narrative content being of little direct materiality in terms of content, its presence in the annual report was a source of reassurance.

*I think that would be an error of judgement to just take out [for example] the risk report even though analysts by and large aren't going to read it. The fact that it's there, you see it's there, you know it's there, gives you some comfort that somebody has thought about it. You look at the risk statement [for example]. You presume there's nothing in there so you don't read it. It doesn't mean necessarily you're not valuing it.*

Most of those who expressed the view that the absence of front end narrative would be missed, explained that one of the major objections would be the omission of previously 'taken-for-granted' content.

Analyst A2:

*When somebody stops disclosing something, then your alarm bells ring automatically. So even if the thing on the face of it is not particularly relevant or you may discount it in the general run of things, if it disappears altogether then that would set alarm bells ringing.*

Interviewer: 'Why so?'

*I think it's slightly the cynical or questioning nature of an analyst that if something had been excluded then you must be hiding something. There must be some ulterior motive for excluding it and that generally has to be seen as a bad thing.*

Interviewer: 'Would it alarm you if the entire front end was missing?'

*Yes... even where the statements themselves are quite bland.*

Similarly, Analyst A17 remarked:

*I think I would [miss it]. If it were not there then still you'd probably... say 'hmm'. If it's not there then you would think, 'well what's been going on?' But yes if it wasn't there then actually we would say, 'wait a minute'.*

Analyst A18 said:

*[If the question is] Is there anything in the front section that I really need, [then] the answer is 'no'. But I think you've still got a flavour of the company [from that content].*

Against these views, however, was a substantial body of opinion that the narrative 'front end' would not be missed at all if removed completely.

Analyst A4 was asked, 'would you be concerned if the whole front end was gone?' and replied, 'Not massively'. When asked whether he or she took any comfort from the narrative content being there, Analyst A4 replied, 'No, I don't really, actually'. Analyst A7 was similarly asked whether he or she would miss the front end, if the document opened at the income statement and balance sheet; the reply was, 'From my point of view that would be absolutely fine.' Analyst A10 said: 'I wouldn't miss it at all. So to my mind it is pure waffle.' Analyst A14, when asked whether he or she drew any comfort from the front end, replied, 'None whatsoever'. The interviewer asked whether Analyst A14 thought it would be acceptable if the annual report arrived without the front end. Analyst A14 replied, 'Yes, absolutely'. Analyst A15 said he or she would 'certainly not' have any problems with the whole front end being removed.



## 6. Discussion

Rather than seeking to provide a range of conclusions and policy recommendations, it is hoped that the evidence provided in this report will assist future researchers in identifying research opportunities and providing them with evidence to enrich existing research findings. In addition to this, however, a number of issues can be raised as a result of the evidence and these fall into the general areas of:

- issues for preparers
- issues for change and analysts' insight.

A final section offers suggestions for further research arising from the findings of this project.

### 6.1 ISSUES FOR PREPARERS

It is curious, given the substantial growth in narrative content over the years, that little systematic evidence exists for the actual manner in which corporate reporting information is consumed. While part of the volumetric increase can be explained in terms of increased regulation and stock market listing requirements, it remains the case that the vast bulk of the increase is due to enhanced voluntary narrative. Although reporters have bulked out their annual reports with more and more content, little is known either about which audiences consume the respective parts of the annual report or the actual or potential investment materialities of those components.

This study has found, however, that at a fundamental level, the narrative contents of annual reports are relatively unimportant to analysts, who are one of the most important primary consumers of corporate reporting information. There was no consensus among the cohort that any given narrative content category was actually or even potentially material and, in most cases, the majority view was that each section was less than useful. Some sections of narrative reporting were seen by the analysts as being of almost no actual or potential materiality at all.

The most common reasons given by analysts for the assumed immateriality of the relevant disclosures were the lack of numerical content, lack of granularity (both of which affect the usability of the information in a financial forecast) or the assumption that their own clients (the buy-side) were not interested in information based on the type of voluntary narrative in question. The attitudes of the buy-side and their perceptions of sell-side information usefulness were not, however, tested in this research. These issues have been flagged as a suggestion for further research at the conclusion of this report.

So who is all this extra disclosure content actually for? Which audiences are conceived of when the content is being drafted? The content as presented appears, for the most part, to be inadequately detailed to feed into analysts' forecasts although there is some evidence that the contents are used to verify information previously acquired. While some disclosure is insufficiently detailed, other parts are arguably too complex for non-sophisticated

users. So it may be the case that some or maybe even most narrative falls 'between two stools' – insufficiently detailed, resolved or granulated for analysts and too complex for non-specialist individual investors.

Some narrative sections were especially poorly thought of by the cohort of analysts. There were very few positive views on the chairman's statement, while the risk narrative was considered largely boiler-plating, and the social and environmental content was universally considered irrelevant. A challenge appears to exist for reporters to take their readers' information needs into greater account when preparing and drafting annual reports.

### 6.2 ISSUES FOR CHANGE AND ANALYSTS' INSIGHT

Evidence from this study suggests that analysts are very systems-driven and do not often think beyond the narrow confines of their roles in the capital market information 'supply chain'. It appears unlikely that they would be a source of pressure for change in terms of the social or environmental performance of businesses they cover as analysts.

They do, however, claim to be sensitive to the information needs of their own clients in the information supply chain. In this respect, it appears that pressure from the buy-side on such issues as environmental performance may cause a sell-side reappraisal of the materiality and value of social and particularly environmental reporting. It may therefore be that investor pressure on the buy-side for, say, filtration by environmental risk, performance or reporting will present pressure for change in the environmental awareness of analysts. There is a small amount of evidence for pressures of this type in the sell-side/buy-side relationship. The Enhanced Analytics Initiative, for example, is an international collaboration between asset owners and managers aimed at encouraging better investment research, in particular research that takes account of non-financial issues on long-term investment.

Internal change among the sell-side analysts themselves in this respect, however, is unlikely. The technocratic nature of the analysts' skill set renders them less amenable to self-critique. The assumptions of capitalism pertaining to the supremacy of short-term growth and returns pervade the analysts' operational activity.

There may be some grounds for questioning the structural appropriateness of the analysts' skill set in interpreting narrative material for the purposes of financial planning, and in respect of the failure to recognise the potential materiality of secondary environmental risk. While the analysts were quick to dismiss narrative reporting as immaterial owing to its inability to be fed into a forecasting model, a case could be made that notwithstanding the perfunctory nature of much narrative reporting, it is the role of the analyst to interpret narrative content for the purposes of amending numerical forecasting. It is difficult to assess where the balance in this lies between the quality of reporting and the skill of the analyst, but the

dismissal of much narrative reporting by analysts may be a de facto admission of an inability to employ narrative content in financial models.

The unwillingness to recognise the possibility of secondary environmental risk may be symptomatic of the short-termism of analysts' financial forecasts. The possibility, at least, has to be admitted that analysts are demonstrating a fiduciary failure to include long-term risk analysis in their reporting, but as criticism of analysts as a cohort is not a purpose of this report this strand of enquiry will be taken no further.

### 6.3 ISSUES FOR FURTHER RESEARCH

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This study has interrogated the user perceptions of annual reports of sell-side analysts, one of the most important (in share allocation terms) audiences of corporate reporting. Given that much of the narrative content of an annual report was considered irrelevant, inadequately resolved and worse ('useless' etc), research opportunities include the interrogation of other user perspectives and analysis of preparer perspectives, especially with regard to narrative reporting.

The cognitive and 'organic' processes involved in the selection of material for, and drafting and editing of, narrative voluntary disclosures remains under-researched. Given that an apparent discontinuity exists between preparers' intentions and user perceptions, research opportunities clearly exist in exploring that. Additionally, if narrative reporting is of little overall use to analysts, research probing the consumption of content by other potential or actual users would be another worthwhile avenue to pursue. Little, for example, is known about the information consumption of small, private investors, non-professional investors and other stakeholders in a reporting company.

In summary, this report suggests a number of worthwhile avenues for further research arising from its findings.

- Further work examining the processes occurring among preparers of voluntary narrative information: in particular, it would be interesting to establish, with a large enough sample, the assumptions of materiality made by preparers with regard to the different categories of voluntary reporting.
- An assessment of buy-side assumptions for the purposes of establishing the extent to which the buy-side need for various information types is met by sell-side reports. In particular, changing attitudes to environmental issues among investors are, given the evidence presented in this report, unlikely to be important to the sell-side but may be more so to buy-side actors.

- The attitudes of sell-side analysts to various voluntary disclosure categories in other industrial sectors, especially the other high volume sectors of oil/gas, pharmaceuticals and technology, where risks and environmental exposures may differ. Similarities found between those and the bank analysts surveyed in this study would emphasise the potential need for change in those areas of voluntary disclosure and any differences could be highlighted for further discussion.
- Studies investigating the manner in which specific voluntary disclosure types are material to investment and to the potential attractiveness of the discloser as an investment. Omissions in material disclosures, perhaps concerning material risks, are one type of failure in this respect while obfuscations and lack of clarity are another.
- A longitudinal study using either qualitative or quantitative research methods to analyse analyst buy/sell recommendations over time and the key factors attributable to changes in recommendations by individual analysts or an analyst group.

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