Developing your annual report

Narrative reporting is playing an increasingly important role in the annual report. Companies can use Integrated Reporting principles to help focus this on the areas that matter most to their business.

Financial reporting plays an essential role in explaining past performance but it cannot provide a complete picture of business value on its own. Shareholders are increasingly looking to narrative reporting as a means to go beyond this ‘business as usual’ perspective.

They want to understand the value being added by management’s plans, and they want to understand the long term value locked in the business and how this is being developed and protected.

The challenge for report preparers has been to develop their existing reporting to provide this in the absence of a compliance framework that defines exactly what needs to be reported.

We believe the answer lies in building your narrative reporting around your business model – telling your story from your perspective rather than a set of reporting rules.

This approach is embodied in the International Integrated Reporting Council’s proposals which are attracting increasing attention from shareholders, report preparers, and regulators.

It is important to recognize the cultural shift required from within the reporting process if companies are to use this approach to communicate the value they are creating more effectively. Preparers will need to recognize their report as a platform to explain what drives the underlying value of the business and how management has acted to develop and protect this. They will need to ask themselves what the reader needs to know, rather than what they are required to be told.

The increased business relevance this can bring to the report should be welcomed but it will be challenging for those who have come to regard the annual report as a regulatory burden rather than a basis for better shareholder dialogue. One key practical implication is that silo-based approaches that delegate report drafting to isolated functions within the business will no longer work. Better business reporting requires a commitment from across the business, not just the finance function.
Three ways to refocus your reporting

1 Concentrate on what’s genuinely important to the business
Step back from the reporting detail and think about what really drives value in your business. For many there will typically be three or four key assets or resources which provide a unique competitive advantage. These assets will be different for every business and may lie in areas such as the customer base, brand, intellectual property, expertise, access to natural resources, and for some, their license to operate. Very often they will not be reflected in the balance sheet – and it would not be helpful to try to do so.

These are assets that lie at the heart of the business’s ability to generate future earnings. Progress in developing and maintaining them is fundamental to the long term value of the business. This needs to be reported on so that the value added by management and the long term prospects of the business can be understood.

The starting point for explaining this should be a description of the assets themselves – what they are, why they are important to the business, and whether the business can rely on the continued availability of the asset. But you will need to go further than this. Readers will want to understand how these assets fit with the changing needs of the business and its operating environment. They will want to see the extent to which they have been developed to meet these requirements.

Take, for example, a business that is dependent on a relatively stable, loyal customer base. A good measure of how this asset is being preserved might be levels of customer retention. Other examples come from the natural resources sector where reporting on estimates of mineral reserves, and movements in those reserves is common practice.

2 Take an operational perspective
What constitutes a good year for your business? It’s likely to be more than just meeting your earnings objectives. Progress made in implementing the business strategy will most likely feature in the assessment, as will progress in building your key business assets, and managing your key risks. Readers need to understand these factors to make an assessment of performance that takes in long term as well as short term value.

Providing this broader view of performance will often require you to look beyond purely financial measures (though financial measures such as growth in target markets may still be very relevant). These measures should typically align broadly with the measures that management is using itself to monitor performance.

A good illustration of this approach can be seen in the pharmaceuticals industry where research and development progress is such a key element of performance. Here, many companies provide an overview of their development pipeline enabling readers to see progress through the different stages of development through to regulatory approval.

The right measures will be different for every business. Finding the right ones to support a more complete picture of performance can require careful thought. Too much information and commercial sensitivities are exposed; too little information and the reporting will lack enough detail to influence readers’ decision making.

3 Help readers take a forward looking perspective
If shareholders are to take a longer term perspective on business value they will need the information to take that view - but businesses are naturally wary of publishing earnings or other forward looking projections. Not least because they may imply a degree of certainty that management simply cannot provide.
A better approach is to help shareholders form their own informed views of future prospects by providing the information to help them take these judgements. This means helping readers understand the factors likely to drive future earnings, and helping them understand the potential impact that these factors might have.

We see an element of this with companies’ risk reporting but there can be a tendency to focus on downside risks to the existing business rather than providing a balanced perspective on risks and opportunities to the future business model. For example, if a key part of your strategy involves growing a particular market, readers will need to understand the opportunity being targeted as well as the challenges the business faces in achieving this.

Readers also need to understand the potential impact that these factors may have on future earnings.

A number of companies are now helping them do this by providing sensitivity analysis (for example on exchange rates or materials prices) based on current year earnings to help readers understand the impact that external factors might have on their business.

**Putting it all together**

In this article we have provided illustrations of the key practical changes to reporting that could be driven by the developing Integrated Reporting Framework. The Framework itself provides guidance on the reporting principles and content elements on which these illustrations are based.

We are starting to see the beginnings of a step change in the quality and relevance of corporate reporting. This development should be of interest to every company that wants to develop their dialogue with shareholders beyond short term measures of performance towards a longer term picture of business value.

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