

Narrative Reporting in Company Annual Accounts

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Abstract

Companies are being pressed to be more transparent in their annual reporting and, at the same time, interest is moving from the formal accounts to the narrative sections, partly in response to the increasing importance of the intangible assets not on the balance sheet. The paper sets out the changes in UK requirements, summarised in a Framework provided by the Worshipful Company of Marketors, and company practice. The two weakest areas in relation to the Accounting Standards Board Reporting Standard are the provision of forward looking information and non-financial KPIs, especially those to do with customers, competitors and brands. The paper suggests that brand equity, the intangible marketing asset, is the present reservoir of future cash flow. Accordingly, provision of professional measures of brand equity should go some way towards solving both weaknesses at the same time.

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Two of the global pressures on company reporting are for greater transparency and better narrative reporting. In an era where intangible assets are increasing dominating, in value terms, the tangible assets, the formal accounts are becoming less reliable indicators of the company's trading and financial position. Enron marked a watershed. The accounts were misleading but, and this is debatable, technically correct. They weaved around the detailed rules for accounts and the information would have been insufficient. Greater transparency is needed and is being demanded by regulators in the EU, USA, Japan and elsewhere.² Given the limitations of formal accounting, these demands have to be met through the narrative sections of company annual reports. Terminology varies and the Chairman's Report, Business Review, Director's Report or Operating and Financial Review is called the narrative report in this article.

The developments in the UK, which pioneered the mandatory publication of the balance sheet back in 1906, has implications for other developed countries especially in a world where reporting practices are converging and companies are multinational. Much of the recent UK development, for example, has been driven by the EU Directive on company reporting in 2003.

A formal OFR (Operating and Financial Review) was mooted by the UK government in 2005 but was deemed burdensome and replaced by a less formal requirement for a Business Review. In practice, the detailed requirements remained much the same. Some companies were sufficiently far down the line when the requirement was withdrawn that they have retained the OFR terminology.

This article sets out the broad requirements for the narrative sections of UK annual reports. We then review the advantage to companies from greater transparency and how companies themselves are changing their practices in that direction. Key areas of difficulty are the provision of non-financial Key Performance Indicators (KPIs or metrics) and forward-looking information. Of course the key question is whether these developments represent measured behavioural change or whether they are merely good intent. We review results from the quantitative scoring of narrative sections of annual reports against the Accounting Standards Board (ASB) guidelines. Whatever the rights and wrongs of the provision of forward-looking information, the solution may lie in the provision of current and historical market metrics since they predict future outcomes. These strands are brought together as conclusions.

What should narratives contain?

The UK Government and the Companies Act 2006 have largely delegated to the ASB the specification of narrative sections of annual reports. The specification is mainly advisory ("best practice") rather than mandatory. This is wise: businesses differ too widely to allow standardisation. What is crucial for one company is not important for another. Furthermore, it seems better to promote the benefits of transparency than create legal requirements for companies to weave their way around.

² For a fascinating long-term review see "U.S. Accounting Standards and Their Environment: A Dualistic Study of Their 75 Years of Change," a lecture by Professor Yuji Ijiri, to the US Accounting Standards Board and Financial Accounting Standards Board, also in *Journal of Accounting and Public Policy*, 24(4, July-August), 2005, 255-279

Thus the ASB issues a “Reporting Standard” and reports on compliance with that Standard. As the current Reporting Standard has 69 pages, and government and leading consultancies have issues hundreds of other pages of advice, there is a need for a brief aide-memoire for those who have to prepare narrative reports. A City of London Livery Company, the Worshipful Company of Marketors, supported by the Marketing Society and the Chartered Institute of Marketors, has therefore provided a synopsis. The first edition, the “Checklist”, was published in September 2005 with eight pages but that was found to be too abbreviated, and a second edition, the “Framework”, published December 2007, has 12. Copies of the Framework can be feely downloaded from www.marketors.org.

The underlying principle of the new narrative reporting guidelines is that it should “set out an analysis of the business through the eyes of the board of directors”³. If a Business Review provides less than the full picture, two conclusions may be drawn: the Board itself has only a partial understanding of their business and/or they are failing to comply with the guidelines. Confidentiality is widely cited as a reason for non-compliance, especially in respect of KPIs. Undoubtedly some topics and metrics are confidential in the sense that their publication would harm the company’s competitiveness. There is also the inherent unfairness of UK PLCs being expected to be transparent while private companies, notably private equity, and foreign competitors are not. Nevertheless, some 80% of details withheld on grounds of confidentiality proved not to be when tested against “would this information give your competitors advantage against you, i.e. would they be interested?”⁴ Competitors do similar market research and already know most of what they want to know.

But that is only true for past data. The ASB Reporting Standard lays great emphasis on the provision of forward-looking information, i.e. what the company will do and the likely consequences. Business plans really are confidential and some see no reason why they should be exposed. Broad statements of strategy and intent may not be competitively sensitive but by that very measure they are not informative. Boilerplate helps no one. It is hard to understand why the idea of providing meaningful forward-looking information has so much traction. Competitive advantage depends on surprise.

Others disagree. The US Securities and Exchange Commission shifted its view from plan historical facts to the provision of forecasts in the 1970s.⁵ Companies are pressed by analysts and major investors to supply forward looking information and, to some extent, do so. Where they meet those requests, they should certainly publish the information also to all shareholders in the narrative reports.

Given these divisions of opinion, it is no surprise that, the lack of provision of forward-looking information is perhaps the largest area where practice does not accord with ASB guidelines. We will suggest a solution later in this paper.

One compromise has been achieved. Directors pointed out that they could be arraigned if they provided forward-looking information in good faith but things worked out differently. The government initially rejected “safe harbour” provisions to cover this problem but relented at a late

³ ASB Reporting Standard (2006), para 4.

⁴ Tim Ambler, Patrick Barwise and Chris Higson (2001) Market metrics: What should we tell the shareholders? Centre for Business Performance, Institute of Chartered Accountants in England and Wales, October.

⁵ Yuri Ijiri, *op.cit.*

stage in the passage of the Companies Act 2006. At least directors will not now go to gaol if they are candid.

The Framework used for scoring narrative reporting practice relative to the ASB Reporting Standard is set out as Figure 1.

Figure 1: Narrative Framework

Context, Nature, Objectives & Strategies

Markets served, e.g. current size and future prospects
Competitive position in markets served and future prospects, e.g. market share, ranking or position
External factors likely to impact future prospects, e.g. legal, regulatory, technological, economic, social, environmental
Corporate objectives: financial and non-financial, quantitative and qualitative goals with some indication of timetable
Economic or business model: how the business adds value, sources and usage of cash flow
Strategic expansion/contraction, e.g. diversifying or changing geographic markets served, product categories or customer types
KPIs/metrics most used by the board to assess progress/performance: both financial and non-financial

Drivers of Development & Performance

Sources of cash flow, e.g. profile of customers, number of end users/consumers, loyalty, churn, penetration, share of wallet, and user consumer attitudes, e.g. satisfaction, perceived quality, intention to purchase
Trade or channel relations (where applicable), e.g. service levels, distribution, display, trade customer satisfaction
Facilities, subsidiaries, markets served and distribution methods: key changes with impact on future cash flow
Competitive effects and performance relative to competitors, e.g. market share, relative pricing
Drivers likely to improve future prospects, e.g. marketing expenditure, sales force changes
Drivers likely to reduce future prospects, e.g. costs, impact of regulations
Innovation, e.g. number of new products, new products' revenue and margin as share of total, R&D investment
Key strengths and resources, e.g. reputation, brand equity, intellectual property, employees, capabilities, diversity
Principal risks and uncertainties, e.g. how key internal and external risks are being addressed
Relationships with other stakeholders: which are most important, why?, implications, risks for cash flow

Financial Position analysis and explanations

Accounting policies, e.g. those necessary to understand the performance and financial position, changes
Capital structure: nature, rationale, short/longer-term plans
Treasury policies: analysis and explanation of cash-related matters
Cash flows, e.g. probable cash requirements, where segmental cash flows are out of line with profits
Liquidity, e.g. working capital, current assets, current and prospective borrowing requirements
Profitability, e.g. sales volume, turnover, gross margins, profit ratios

Companies find compliance with the first section, which is largely in the public domain anyway, and the third section, which amplifies the accounts, fairly straightforward. As the ASB review of

2006 reports showed, the middle one presents the problems. The ASB review was based on their own analysis, supplemented by five independent studies.⁶

We now consider the benefits to companies from greater transparency before returning to the question of how practice is developing and the problem areas, notably marketing.

The benefits of transparency

Companies are more likely to embrace the spirit of the ASB Reporting Standard if they see advantage in so doing. Otherwise they will do the minimum needed to keep out of trouble. Black Sun, a consultancy that specialises in helping companies with their annual reports, sponsors research exploring this issue. Two London Business School students⁷, as part of this activity, tested whether increased transparency in narrative reporting has led to an improvement in the following areas:

1. Performance Management
2. Risk Management
3. Internal Coordination and Communication
4. Strategic Development
5. Investor Relations.

As one would expect, there were wide differences of opinion, but on average, respondents claimed that their companies benefited from providing increased transparency in annual report narratives in all the above respects except strategic development. The Mediratta and Jain Table 1 is reproduced below:

Table 1: Summary Results

Percentage of respondents who reported a benefit from increased transparency in the narrative on a particular dimension

Dimension	Agree	Disagree	Neither
Performance Management	76%	24%	-
Risk Management	66%	34%	-
Internal Coordination and Communication	76%	12%	12%
Strategic Development	41%	59%	-
Investor Relations	92%	4%	4%

⁶ ASB. A Review of Narrative Reporting by UK Listed Companies in 2006 (January 2007)

⁷ Anshul Mediratta and Saurav Jain (2007), *Evaluating the impact of increased transparency in the narrative section of a company's annual report on its internal functioning and its investor relations*, MBA Project Report, London Business School

These results imply that companies have to, and will, do better in performance management, and presumably measurement, if they know they will be publicising that. Likewise, risk will probably be better managed or at least more considered if one has to explain oneself. The third one is especially interesting. Companies are often criticised for not keeping employees informed about the main corporate issues. Those that fully report to shareholders, however, find it relatively simpler to relay the same information to employees.

Gaining competitive advantage and how that can be achieved is something, as noted above, that companies may well wish to keep under wraps. Publicity can only rarely help that. One example is pre-announcing a new model which can deter competitors from similar launches. Few such opportunities arise. In the light of this, it is perhaps surprising that as many as 41% agreed that transparency was helpful in this respect.

On the other hand, the benefits of transparency for investor relations are the most obvious attractions and likely to top most lists. Marketing the company to existing and potential shareholders should encourage them to buy more shares and at higher prices. A large part of that is understanding the needs of shareholders and especially the need for honest and open communications.

But are company practices actually changing?

According to the ASB Report referenced above, companies generally meet the legal reporting requirements (“compliance”) but fall short in some of the “best practice” areas. They did not compare progress year on year but this will presumably follow in due course. Among their conclusions were (pp.2-3):

“Areas of good reporting

- Companies are generally good at providing **descriptions of their business and markets**, together with their **strategies and objectives**, although some improvements can be made in providing information on their external environment.
- All companies within the sample are providing satisfactory or better descriptions of the **current development and performance** of the business.
- There has been an increase in companies reporting **environmental, employee and social issues**, although very few companies have discussed their contractual arrangements and relationships in any depth.

Areas for improvement

- The greatest area of difficulty for companies when producing their narrative reports is the disclosure of **forward-looking information**. The proposed ‘safe harbour’ provisions in the Companies Act 2006 may encourage companies to provide greater detail moving forward.
- Companies need to think carefully about the description of the **resources** available to the entity, in particular on those intangible items not reflected in the balance sheet.”

These, then, are the two negatives: lack of forward-looking information and specifics on brand equity, which for many if not most companies is by far their most valuable asset but not one that appears on the balance sheet. The next section will consider whether providing brand equity metrics resolves the issue about forward-looking information, since brand equity is a proxy for

future cash flows. Before turning to this topic, however, we will review some additional data on disclosure.

PricewaterhouseCoopers however showed remarkable developments in narrative reporting in their Narrative Reporting Survey 2007 (figures from a survey a year earlier in parentheses):⁸

- “93% (66%) of companies provide some disclosure around their strategic objectives.
- 75% (19%) of companies clearly disclose their KPIs.
- 75% (22%) of companies clearly set out what they consider to be their principal risks and uncertainties.”

On the other hand:

- “Only 35% of companies support their strategic statements with targets, qualitative or quantitative.
- Only 42% of companies clearly align their KPIs with their strategic priorities. And when presented these tend to be financial in nature.”

Even with the qualifications, this is a rapid increase in practice. Some of their figures are supported by Black Sun research:⁹

- “98% of companies now clearly communicate strategy, with over three quarters of companies now providing objectives and business targets, up from 40% 12 months ago.
- 88% of companies include information on market trends and 43% include independent data to help improve understanding.”

In reviewing the position from an entirely different perspective, Peter Montagnon¹⁰, representing major investors, was not quite so sanguine. He did not accept that all companies are producing KPIs that are helpful; and some were not producing many or any non-financial ones, although he expected that to change. In thinking about KPIs, we do not need too many, nor trying to please everybody all of the time, still less companies’ choice of KPIs being dictated by the public policy agenda. In his view, KPIs should help the understanding of what is material to the business.

The other top-line PWC findings were that of all companies in the FTSE350:

- “75% clearly disclose their principal risks and uncertainties
- 35% support their strategic statements with targets – qualitative or quantitative
- 41% provide information on the trends and factors likely to impact on their market place.”
(p.4)

These high rates of apparent compliance are flattered, as Montagnon implied, by the use of financial KPIs already largely available from the accounts and analysts. Black Sun (p.5) says “many companies are still struggling to provide meaningful non-financial metrics.” Perhaps the most remarkable aspect of the evaluation of narratives is how little attention is given to marketing (the sourcing and harvesting of cash flow) and/or brand equity (the marketing asset which, for most

⁸ *Business Review: has it made a difference? A survey of the narrative reporting practices of the FTSE 350*, p.6.

⁹ *The complete FTSE100: where are we now?* Summer 2007, p.5.

¹⁰ Director of Investment Affairs, Association of British Insurers, Wednesday 20 June 2007, Seminar at the Selfridge Hotel, London.

companies, is their most valuable asset). PWC (p.17) say “A more in-depth analysis shows that the priorities and KPIs that have been aligned are primarily financial. What signal does this send to the outside world if resources such as people, customers, suppliers and brands are identified as key without supporting them with appropriate KPIs?” In their research, KPIs for brands do not register at all. Reflecting these attitudes, Black Sun also paid no attention to marketing or branding.

An analysis of the KPIs used in the FTSE100 company annual reports, underlines this point.¹¹ Table 2 shows how the 303 KPIs used in the narrative reports (3.3 per company) divided by type of metric

Table 2: KPIs reported by FTSE100 companies

	Percent
Financial	55.4
Employee	18.5
Environment	15.8
Trading market	6.9
Community	2
Other	1.3

Source: Black Sun, email 12th November 2007

The 21 (trading) market, or marketing, metrics reported are shown by Table 3.

Table 3: Market KPIs reported by FTSE100 companies

	# mentions
Customer satisfaction	12
Market share	3
Brand growth	2
Customer churn	2
Brand perception	1
Customer service	1
Total	21

Readers of narrative reports need to see how KPIs change from year to year. PWC is gentle again (p.17): “Companies’ strategies evolve over time, so it should come as no surprise that only half of the KPIs disclosed were consistent year-on-year. In itself this should not be an issue. The opportunity remains, however, for companies to disclose and explain more clearly the changes that have been made.”

The Worshipful Company of Marketors sponsored research by two London Business School students, Gonzalo Barreto and Antonio Risso, to refine the scoring system for narrative reporting (Figure 1) and apply it to the FTSE50 company annual reports.¹²

¹¹ The analysis by Black Sun was of the 90 companies with year ends between December 2006 and July 2007 and excluded non-standard KPIs, i.e. ones applying to that particular sector only.

¹² “Towards an Objective Scoring System to Rank the Corporate Narrative Sections of Annual Reports” London Business School, Second Year Project, MBA 2007

AstraZeneca scored most highly in terms of best narrative reporting practice with Cadbury and Vodafone ranked 2nd and 3rd respectively. Their scores were close with a mean 73%, i.e. they were 73% of the ideal best practice according to the ASB Reporting Standard. At the other end, Sainsbury, Imperial Tobacco, SAB Miller and Tesco, with a mean 40%, showed significant scope for improvement. The overall mean score was just under 60%.

The next section considers a practical approach for improving this performance without damaging competitiveness.

Can two negatives make a positive?

Brand equity is becoming a widely used term, including in the ASB Reporting Standard, although it is not always fully understood. It is an intangible asset created by good marketing and, other things equal, later becomes tangible in the shape of net cash flow. In other words, a primary role of marketing in the short-term is to create demand which pays back in the longer term. Accordingly, if we could reliably measure brand equity, we would have objective predictions of future cash flow.

Best practice is therefore to identify those past measures of brand equity that have predicted cash flows today. We cannot be sure history will repeat itself but at least this analysis provides some indication of the metrics, or KPIs, that the board needs to track, and also report to shareholders. Thus the board can provide forward-looking information in the shape of current market research and internal data. Both sides should be satisfied: those demanding forward-looking information and those reluctant to provide speculation about the future or confidential plans.

Boards can and should be judged by the extent they have built these intangible assets, storehouses of future profit, alongside their short-term financial performance. As Table 3 shows, in practice only a tiny minority make any effort to report on their trading market metrics or brand equity and yet this is where the cash comes from.

One popular measure of brand equity, although it did not show up on Table 3, is its value. The main methodology for brand valuation, or estimating customer equity as it is sometimes called, is to predict future cash flows and convert them to net present value. The problems with that methodology for reporting purposes are that future cash flows cannot be known with any certainty and present values depend on extrinsic factors such as future rates of interest. Furthermore future cash flows cannot be distinguished between those due to past and future marketing activities. A company is entitled to take credit for the former but not the latter.

The long-running debate about whether brand values should appear on balance sheets is sterile, however, for a different reason. A company is entitled to report and track brand values in the narrative parts of their annual reports and some do so. If the value of their brand is both a metric used by the Board to monitor the business and useful information for shareholders, then reporting it is good practice. Providing the information to shareholders matters but whether it appears in the narrative or formal accounts is relatively immaterial. Thus it is unnecessary to include brand valuations in the balance sheet whatever the accounting rules may be.

The purpose of marketing is to create the demand that the company can profitably meet. In other words, it is the creation and harvesting of cash flow. Marketing and corporate performance are much the same: ultimate success for both is measured by long-term cash flow. As noted above, the

problem is that we are never at “ultimate”: in practice performance can only be measured by cash flow to date plus current indicators of future cash flow. We can measure the past and the present but not the future. Thus, as discussed above, current indicators of future profits are also measures of brand equity.

Shareholders do not want forecasts based on guesswork; they want forward-looking information based on evidence and experience. Brand equity metrics should be gathered professionally, i.e. they should be present day, factual evidence. The choice of measures should be based, in part at least, on their ability to predict subsequent profits and cash flow.

As discussed above, narrative reporting is rapidly converging on the ASB Reporting Standard except in two main areas: forward-looking information and non-financial KPIs, notably those that marketers would see as brand equity. Some other areas are also weak but these two are crucial for determining the company’s future prospects. We can make those two negatives into a positive by focusing on brand equity metrics. Providing the evidence that the Board itself uses for future expectations meets the key guiding principle of the Reporting Standard: “seeing the business through the eyes of the directors”. Then observers have the evidence they need to do their own projections.

At the same time it does not undermine competitiveness nor require the directors to indulge in speculative forecasts.

Conclusions

Narrative reporting in public company accounts has been developing fast in response to establishment pressures such as the new ASB Reporting Standard and Companies Act 2006, and also the growing recognition that greater transparency has benefits for the companies themselves, notably for performance measurement and management, risk management, internal communication and coordination and investor relations. It makes good sense that more shares will be traded and at higher prices if the company is well marketed to the City, and that in turn requires better communications and transparency.

Reporting on these developments varies from the self-congratulatory to the cynical but there is no doubt that company practice has changed from poor to average. The marks in one research project reported ranged from 40% to 73% with a mean for the FTSE50 of 60%. The scale was complete non-compliance (0%) to ideal compliance with the ASB Reporting Standard. Encouraging but room for improvement.

Within this pattern of increasing convergence with the ASB guidelines, which are largely advisory, lie a number of weaknesses. The two with which this paper has been most concerned are the lack of provision of forward-looking information and non-financial KPIs, notably measures of brand equity. These are the two big negatives.

There are good reasons for the former. Even with the new safe harbour provisions, it is unrealistic to expect directors to provide either their forward business plans in meaningful detail or forecasts which must be riddled with uncertainties. And if the information is merely boilerplate, i.e. not meaningful, there is little point in providing it.

On the other hand, marketing KPIs, i.e. brand equity metrics, are largely known to competitors, and are factual indicators professionally and independently gathered. A dashboard of such measures is what any Board should use to drive the business. What directors see and use is, where competitively reasonable, what they should include in their narrative reports. And by so doing, they will turn the two current negatives into a future positive.

Similar developments are likely elsewhere. The idea that the annual report should show the business through the eyes of the directors came from Canada. Whilst the new requirements, such as the US 2002 Sarbanes-Oxley Act, may be initially seen as burdensome, some companies are increasingly recognising the benefits of greater transparency in their narrative reporting.