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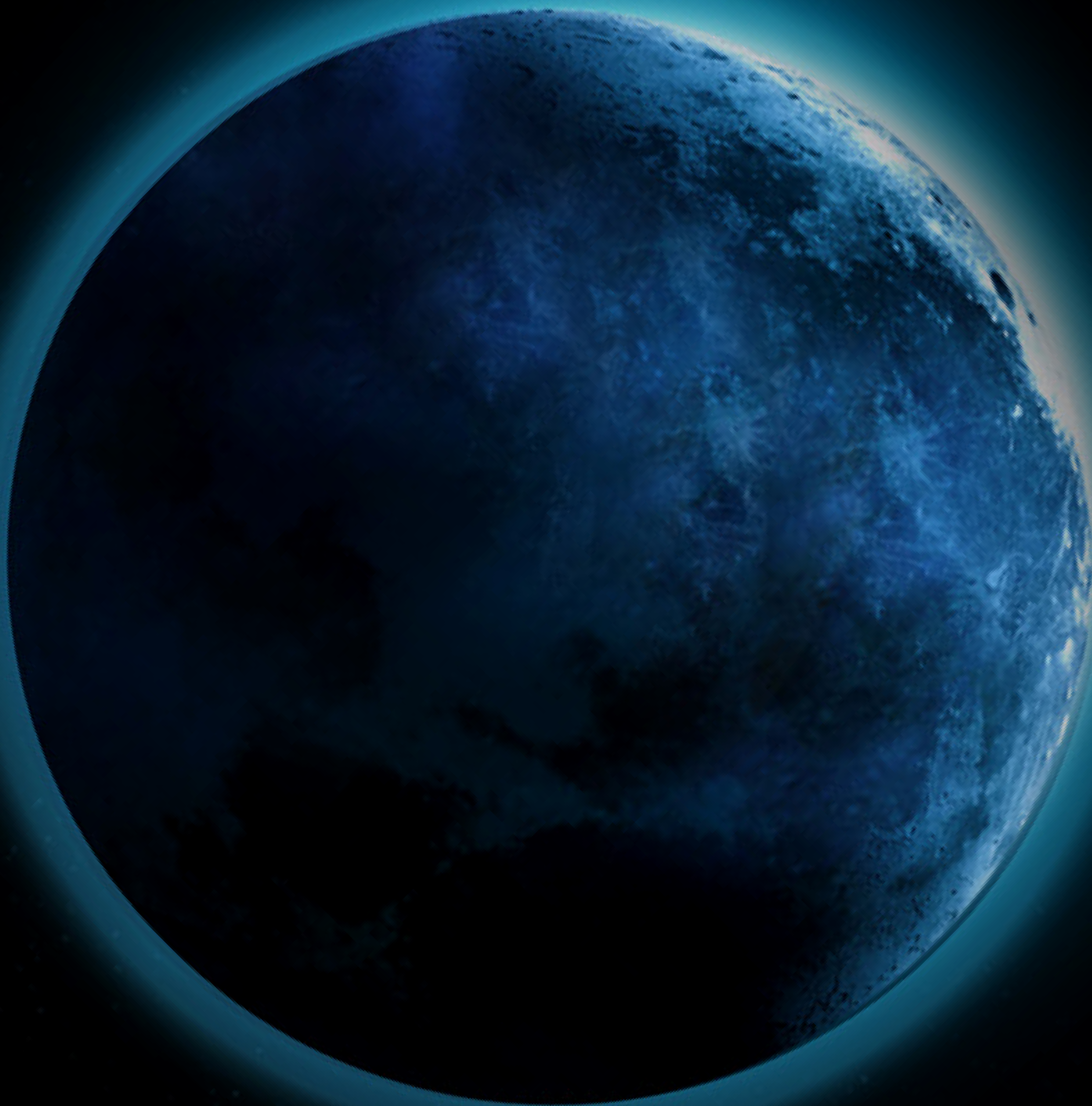

Is more less? Exploring a new world of corporate reporting

Part 2: Beyond the status quo

Audit & Assurance

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A professional appetite for progress

In the first part of our series, ***Is more less? Exploring a new world of corporate reporting,*** we put forward the hypothesis that if corporate reporting were redesigned so that stakeholders could access everything they need – no more and no less – then public companies would be more effective at demonstrating value and at delivering useful information to the market, thus enabling more informed decision-making by constituents.

We want to thank the large number of you who took time to engage with us on this topic. We've been heartened to learn through our many conversations with you that not only do you agree, you also had some great suggestions for improvement.

You get that there's a great deal of information delivered through the current corporate reporting framework that, due to volume and complexity, often doesn't actually help people decide where to invest their money or how to better understand the business. For readers, it can be like looking for gold flakes in a muddy river.

But you also understand why reporting has become so overwhelming: the amount and complexity of mandatory disclosure as well as the sheer volume of information being generated has exploded in recent years. It's no wonder many report preparers are guided more by a need to fully comply with the rules to avoid litigation and a wish to minimize the potential impact of social media chatter on a company's market value than they are by clarity and usefulness.

We believe it's time for corporate reports to refocus on their primary purpose: to inform stakeholders. Our discussions with you confirmed that balance sheets and income statements continue to provide value, and that while the MD&A is considered the most useful source of information in the current framework (i.e., the best we've got), it could deliver so much more.

Everyone we've spoken with – directors, preparers, regulators, standard setters and accounting professionals – believes we can better inform stakeholders and supports the need for change.

In this installment, called Beyond the status quo, we look at changes that could be made within the existing framework to make corporate reports more understandable and more useful – in other words, better. Some companies have already achieved this goal, and the changes they implemented aren't earth-shatteringly complicated. But that is only one part of the story: forces outside a company's control also contribute to the overall complexity of corporate reporting – such as what others say about the company on social media and elsewhere. We'll explore the impact of these elements on the framework as well.

Make the most of what we've got

While you have suggested a number of ways improvements can be made, we have focused on four critical areas, or pillars, that should be addressed to make corporate reports more useful for everyone.

Using plainer language, prioritizing information (including deciding what to leave out) and making better use of technology for online reports can all be accomplished in-house, while standardizing non-GAAP measures such as EBITDA and free cash flow can be achieved through industry-wide cooperation. The goal is not about making it easier to do the minimum. It's about making a company's overall business performance clear as day, including why key decisions were made as well as the results of those decisions.

Consider Warren Buffett's famous annual letters to Berkshire Hathaway shareholders. They are renowned for being matter-of-fact, full of personality, easy to read and, for all that, no less informative. And there's no real secret to it, either: Buffett simply observes fundamentals of communication, principally the desire to be understood, to connect with his readers at the most basic, human level. He's not writing to computers, he's writing to other people. And it shows.

Thus:

1. Use plain language

The convoluted language of many corporate reports makes for heavy reading and opens up the potential for misunderstanding. The standards for writing MD&As stipulate they should be in plain language, so that the lay investor can easily understand them.

That means that even though the average MD&A isn't particularly poorly written in a technical sense, it tends to suffer from a lack of clarity. There's often excessive jargon, repetition of information found in companion reports, too much information that's probably not relevant, and insufficient focus on providing meaningful analysis of key changes since the previous report. In short, a whole lot of words that don't say much.

Plain language, and imagery where appropriate, communicates the clearest, strongest message. And often, the most memorable: "The best thing that happens to us is when a great company gets into temporary trouble...We want to buy them when they're on the operating table."1 That image, evoked by Buffett, takes few words but conveys a vivid understanding.

The "Oracle of Omaha" also has a down-to-earth style, using the first names of senior executives, taking personal responsibility for missteps and not shying away from humour in his annual letters. For example, writing about investors who are overly concerned about the near future: "If you are a CEO who has some large, profitable project you are shelving because of short-term worries, call Berkshire. Let us unburden you."2

His letters are an example of what could (nay, should) be done with the MD&A: the data and the facts are there, but so is the context for decisions, explanations of any stock price fluctuations of note, and anything the executive team feels might need clarification.

Aside from a fear of non-compliance, another factor keeping the fat on these corporate reports is lack of time. Many preparers are overwhelmed and figuring out how to do things differently merely adds to the workload. Some companies do the bare minimum required of them. In fact, some companies produce MD&As that are so sparse as to verge on over-simplistic, divulging so little information that readers don't get a clear picture of what's happening and what the company's prospects are. Such reports may be simpler, but they're not necessarily better. Getting the balance right between clarity and meaningful information would provide their investors – present and potential – great value.

2. Choose what matters

Clarity is achieved not only through word choice but also by emphasizing the important issues – and in their order of importance. If you go to the medical clinic with a broken arm, a paper cut and indigestion, in what order would you tell the doctor about your ailments? Would you mention all as being equally important?

MD&As could present a clear path to decision-making but instead they're often a tangle. The result is that much of what could and should be analysis is actually the repetition of information presented elsewhere, with no further context, explanation or insight. Why is this so? Risk aversion and legal concerns may drive preparers to err on the side of caution.

Ultimately, presenting information in order and proportion of its significance to the organization's operations is, as Mr. Spock might say, only logical. We think that, of all available reporting vehicles, the MD&A has the most opportunity for enhancement in this regard. As a complementary piece to the financial statement, it should paint a clear and comprehensive picture of what's happened and, more importantly, why: Why did a particular product do better, or worse, than expected? Why did the company decide to buy that firm

whose main product is becoming obsolete? Why was that department eliminated? These decisions are best explained in words, in addition to the dollar impact they have on the financial results.

Restructuring the MD&A may be required. Additions to consider include an executive summary, a stratification of risk factors (industry-wide as well as company-specific) and a strategic report setting out the senior executives' objectives for the near- and long-term – not only the immediate results. All of this is also best supported by far clearer graphics, charts and other imagery to help the reader understand the story being told.

3. Tap into technology

Most companies know they must make their information readily available on the Internet. And so they post PDFs on their websites, static and unilateral, just like the printed versions. This isn't enough. This approach fails to take into account the sea change in technology, in the growing appetite for information and in investors' corresponding expectations regarding access to that information.

The potential to deliver more reader-friendly reports could be achieved by taking full advantage of tools such as:

- Searchable text: Allows users to quickly locate specific information; collapsible sections permit a cleaner presentation.
- Hyperlinks: The main narrative remains laser-focused but readers can choose to read more deeply on side topics. The hyperlinks can be to internal material – financial statements, other reporting documents or a press release announcing a major acquisition – or external, such as an analyst's report or a media story.
- Analytical dashboards: Permit users to drill down into the details and easily compare and contrast numbers.
- Tagging: Machine-readable tags called eXtensible Business Reporting Language (XBRL) let users import data into spreadsheets to compare and analyze a company's financials. (The Securities and Exchange Commission [SEC] in the U.S. requires to use this tool.)
- Graphics: Shoulder a good deal of material in a highly digestible manner, if well done.

An interactive report model allows readers to explore as they see fit and arrange information the way they want to see it. We believe that when organizations take full advantage of existing technology, they help their audiences find specific information, better understand it, more easily analyze it and more fully appreciate marketplace reactions to various decisions. The return on this investment for companies is that such reports may help them better attract and retain shareholders.

4. Standardize measures

Accounting rules are now designed to best portray the financial position of companies at a point in time, notably in the balance sheet. The result of this focus on the balance sheet is that many changes flow to the income statement or statement of comprehensive income as an offset to the balance sheet accounts. It's like wanting to keep the living room impeccable so everything that doesn't belong is moved to the basement, which then becomes a mess. That's why most organizations now report measures that aren't subject to accounting standards – non-GAAP measures – in order to present a more accurate version of operational performance.

According to recent research,3 the most important measure and commonly used yardstick for many companies is EBITDA: earnings before interest, tax, depreciation and amortization. However, while there are some common approaches for calculating EBITDA, there are no formal standards and organizations may well do it differently. On top of that, most companies further "normalize" those results to report an adjusted EBITDA. There is far wider variance in those normalizing adjustments and, therefore, less consistency. Even though it may well be the most widely used measure, many believe EBITDA is flawed because it does not take capital into account and that the free cash flow measure might be preferred. Some combination of measures may therefore be more informative for most organizations.

We think it may be worthwhile to work with your industry and our accounting bodies to standardize the definitions of EBITDA, adjusted EBITDA and other non-GAAP financial measurements – free cash flow, in particular. The reason is clear: it helps investors, and others, analyze key performance measures, compare progress from period to period and compare data between companies. Some change is already afoot: CPA Canada worked with the real estate industry to provide guidance on a standardized meaning of free cash flow; thanks to this new common meaning, entities can now be more easily compared.

More ideas

Our frank discussions with you, along with our research on this topic, yielded a number of other suggestions for improvements that could be made to corporate reporting within the confines of the existing framework. Here's a sample:

- **Use** the President's Report to tell the full story and reference the appropriate reporting documents as required (the President's Report is not restricted by regulation and can be a free form, plain language document).
- **Consider** sharing insights from matters that are reported to the board on the company's direction (or internal reports used to understand performance), such as a strategic report in the MD&A or President's Report.
- **Reorder** the financial statement notes in order of importance instead of order of appearance on the financial statements (a currently proposed amendment to standard "IAS 1" would allow this).
- **Include** a question-and-answer section that anticipates questions and provides their answers.
- **Benchmark** performance in key areas against peer groups and provide summaries.
- **Increase** use of graphs, pictures and charts to replace long narrative explanations.4
- **Integrate** corporate reporting with social media platforms, such as LinkedIn.5

Crisis? What crisis? Responding to outside chatter

Committing to enhancing the financial documents they produce to make their story as clear as possible to their stakeholders and the market is a major undertaking for Canadian businesses. Yet it's only half the equation, the part they can control.

What others say about a company may have an even greater effect on its value, particularly in the short term, and it's often completely out of the company's hands: comments on Twitter about a negative experience, an influential analyst's less-than-glowing forecast, a blog post containing outright incorrect facts.

Most if not all businesses know they have to stay on top of Facebook posts, tweets, blogs and the like, and many employ sophisticated programs to monitor and manage analysts and media – especially in responding to negative product or service comments, which can quickly amplify. This is singularly important in industries like consumer business where brand reputation is very closely linked to product performance. Many retailers have dedicated monitoring of their social media portals to enable real-time response to customer comments – they want to ward off negative brand identification and let their customers know they've been heard. What if companies used this type of lens to deal with the financial reporting aspect of external information? There are likely fewer tweets from outside stakeholders about an organization's capital expansion plan than about a popular product's malfunction, but the theory is the same.

We contend that, within limits, companies can find a measured way to get their messages across in response to external commentary that could negatively affect their brand and, ultimately, their market value. Managing relationships with, and the information that flows to, institutional investors, analysts and the media goes a long way to ensuring a company takes a leadership role in how it's perceived by the markets. It can provide useful context, correct misinformation and re-affirm its position directly with its stakeholders, all in the concerted effort to share transparent and useful information.

The trick is in striking the right balance between under-reaction (the status quo for corporate reports and investor communications) and over-reaction (vociferously countering every single error of fact or unsubstantiated claim). Organizations need to consider the level at which they will escalate action when they design, or update, their protocols for managing external reports. At the very least, they ought to monitor mentions on social media, by analysts and by media, among other sources, to be aware of the public discourse and how they might respond in future disclosures.

The next steps

We believe it is entirely possible to make corporate reports simpler and better within the current framework.

Using plain language, emphasizing the important information and leaving out the trivial, employing the technology with which we're already familiar and establishing guidelines for addressing external commentary can all be done relatively easily and internally. Standardizing non-GAAP financial measures in particular takes cooperation between businesses, but doesn't necessarily require regulatory approval.

Most of these measures aren't particularly difficult, but they will take time – and will – to implement. It's not up to someone else: it's up to you to roll up your sleeves. Whether you're a director, preparer, regulator, standard setter or accounting professional, everyone needs to commit to helping improve the information flowing to stakeholders.

In the next installments of this series, we'll focus on other aspects of moving well beyond the status quo. We'll evaluate new frameworks and other proposals for change in investor communications. We'll also consider other ways to enhance information quality and provide more assurance over critical data released to the public.

We hope you'll continue to share your perspective and ideas on these matters with us. If you'd like to contribute to the discussion, feel free to contact one of the Deloitte leaders listed at the back of this document or write to us at **corporatereporting@deloitte.ca.**

In the meantime, we'll leave you with this final thought from Warren Buffett: "Investors should remember that their scorecard is not computed using Olympic-diving methods: Degree-of-difficulty doesn't count. If you are right about a business whose value is largely dependent on a single key factor that is both easy to understand and enduring, the payoff is the same as if you had correctly analyzed an investment alternative characterized by many constantly shifting and complex variables."6

We believe that's a lesson worth learning.

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The series Is more less? Exploring a new world of corporate reporting comprises:

1. ***Plotting the course:*** Sets the context for the conversation and raises questions for discussion
2. ***Beyond the status quo:*** Examines how investors can be better informed within the current model
3. ***Looking to the future:*** Evaluates recently introduced frameworks and other proposals for potential changes in investor communication.
4. ***Raising the game:*** Looks at other ways to enhance the quality of information and provide more assurance over other critical data that is released publicly; how the accounting profession can be more engaged in providing assistance.

Endnotes

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4. Initiative on rethinking corporate disclosure, Institute for Corporate Responsibility (at George Washington University School of Business) and the Center for Audit Quality, 2014. http://www.thecaq.org/docs/reports-and-publications/initiative-on-rethinking-financial-disclosure-report---november-2014.pdf?sfvrsn=4
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