It’s not what you think it is

The importance of narrative reporting

Fluctuations in world economies the past few years have prompted organizations to rethink the way they define, assess and measure corporate performance. Board members and executives are continually seeking ways to enhance the tools that link corporate strategy to performance and so to improve effective communication with investors and stakeholders in their narrative reporting.
Information provided in financial statements alone may not be sufficient for investors and stakeholders to gauge the economic value that a company has already created or its value-creating potential and to foresee the sustainability of current performance and cash flows.

Providing consistent quantitative and narrative reports to accompany financial statements is key to enhancing the relevance and transparency of the information disclosed by a company. Narrative reports can be presented in the form of “Management Discussion and Analysis,” “Operating Financial Review” or other “Management Commentary.” Narrative reports are reinforced by financial and non-financial Key Performance Indicators (KPIs) that support the explanation of business strategy and explain progress towards stated goals.

IFRS Practice Statement
Management Commentary (MC)

On 8 December 2010, the International Accounting Standards Board (IASB) published an International Financial Reporting Standard (IFRS) Practice Statement Management Commentary, a broad, non-binding framework for the presentation of narrative reporting to accompany financial statements prepared in accordance with IFRS.

Management Commentary is a narrative report that accompanies, but is presented outside of, the financial statements, setting out management’s explanation of the enterprise’s financial condition, changes in financial condition, results of operations and causes of changes in material line items. Many entities see Management Commentary as an important element of their communication with the capital markets, supplementing, as well as complementing, the financial statements.

In a press release, the IASB said that management commentary fulfils an important role by providing users of financial statements with a historical as well as a prospective commentary on the entity’s financial position, financial performance and cash flows. It serves as a basis for understanding the management’s objectives and strategies for achieving those objectives.

The IASB added that the Practice Statement allows companies to adapt the information provided to particular aspects of their business, including the legal and economic circumstances of individual jurisdictions. This flexible approach will generate more meaningful disclosures about the most important resources, risks and relationships that can affect an entity’s value and how they are managed.

The Practice Statement is not an IFRS. Consequently, entities applying IFRS are not required to comply with it. IASB Chairman Sir David Tweedie said, “Management Commentary is one of the most interesting parts of the annual report. It provides management with an opportunity to add context to the published financial information, and to explain their future strategy and objectives. It is also becoming increasingly important in the reporting of non-financial metrics such as sustainability and environmental reporting. The publication of this Practice Statement will benefit both users and preparers by enhancing the international consistency of this important source of information.”
Key Performance Indicators

KPIs have become largely used by practitioners and are an essential part of narrative reporting. Organizations have long used and reported various performance measures, but to what extent are KPIs well understood and properly labeled? Below are fundamental characteristics of each component of the term “Key Performance Indicators.”

KEY indicator

There are large numbers of performance indicators, but few are ‘Key.’ Board of Directors and Executive Committees need to set out and define the performance indicators that are truly key and relevant to their organization. The essential elements that can be considered to make indicators a performance key include the following:

• Focusing on KPIs that align with the business strategy to link and measure an organization’s progress and its strategic priorities;
• Focusing on the industry in which the organization operates: different measures are applied across industries;
• Choosing KPIs that are used in a company’s internal decision-making process and in managing the business and assessing progress against defined strategies;
• Choosing KPIs that are relevant to the company but are not necessarily used or reported by peers. In this case, management should provide adequate explanation for its choice of KPIs, which should be accompanied with details on the measurement methods used in order to allow external readers to benchmark with other peer groups.

Using and reporting a wide number of performance measures, without focusing on leading indicators, weakens the level of transparency and potentially misleads readers. It is also likely that, internally, managers become overwhelmed and frustrated while tracking multiple performance measures and struggle to enhance them. Consequently, they become less focused on those measures that directly relate to strategic objectives. Generally, the number of KPIs should be fewer than ten.

PERFORMANCE management

KPIs should effectively measure the organization’s ‘performance’ by only taking into consideration factors that are influenced by management. It is essential to understand and quantify factors affecting an organization’s performance that are outside management’s control. Take for example the case of a bank whose improving profits are attributable to changing rates and not to increased efficiency, or the case of a steel producer, whose growing earning per share comes from rising steel prices. These factors should be stripped out or adequately explained when measuring performance.

INDICATORS of future performance

Excessive reliance on historical financial measures prevents KPIs from being true indicators. Assessing financial performance based on current and past results remains subjective in certain cases. For instance, organizations can easily manipulate earnings per share and managers can decide when to book revenues and costs. Accordingly, measuring an organization’s financial performance based on historical growth and returns on capital should be supplemented by ‘indicators’ of future performance, which allows for assessing the sustainability of that performance and provides a glimpse into the future. On the other hand, performance measures should be reported in a timely manner in order to allow management to react quickly and take corrective action where necessary.

The continuous enhancement of narrative reporting is critical to gain and build the trust of investors. It simply entails the disclosure of relevant financial information in a consistent way while avoiding redundant and complex information and ensuring balance between transparency and confidentiality.

by Zahi Zeini, partner, Audit, Deloitte, Lebanon