International
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Project on Business Reporting
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Business Reporting Through the Lens of the Investor

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For the third part in its series on business reporting (see also "IFAC project on business reporting"), IFAC interviewed six specialists with close ties to the investment community to get their recommendations on how to improve business reporting.

From their different perspectives, the six interviewees provided their insights into a number of significant business reporting issues, such as complexity, information overload, fair value accounting, operational performance, convergence of accounting standards, real-time reporting, management commentary, and sustainability reporting. According to Tanya Branwhite, executive director, strategy research at Macquarie Securities, all these reporting issues indicate that "there is an urgent need for users to get more involved in the discussions and decisions about the presentation of financial accounts." She adds to that: "We can't be critical of the accounting standard-setting process unless we get involved and try to put forward solutions to some of the issues.

From the investor's perspective

The investors agreed that financial statements must serve the needs of a broad range of stakeholders. "Shareowners are entitled to information about the company they own. And it is only with that information that they can effectively engage with the company," says Michael McKersie, assistant director, capital markets at the Association of British Insurers (ABI), the largest single group of investors in the UK. Matthew Waldron, director of the Financial Reporting Policy Group at US-based CFA Institute, quotes the first principle in his institute's *Comprehensive Business Reporting Model* (2007): "The primary financial statements must provide the information needed by equity investors, creditors, and other suppliers of risk capital."

According to those interviewed, directors and management may not realize how critically important their financial reports are to investor confidence and decision making, and the overall stability and growth of their business. "Senior executives and board members need to recognize that, essentially, they are working for the benefit of the shareowners," according to James Allen, director of capital markets policy for CFA Institute. "Companies and boards need to have their feet held to the fire both by shareowners (and by regulators) to make sure that they are governing themselves the way that they said they would." Hong-Kong-based investor and shareholder activist David Webb adds, "It is the job of directors to tell the truth, to provide the information that investors need to make informed decisions." Many directors realize that "the largest part of their company's intangible value is the confidence investors have in the management team," says Carlos Madrazo, head of investor relations at Mexico-based Grupo Televisa. "Unfortunately," says Ms. Branwhite, "the way financial reporting has developed has been more from the accounting perspective than the user perspective."

IFAC Project on Business Reporting

In response to the report, *Financial Reporting Supply Chain: Current Perspectives and Directions* (March 2008), IFAC established a project group* to study progress in the areas of governance, financial reporting, and auditing. *Developments in the Financial Reporting Supply Chain—Results from a Global Study among IFAC Member Bodies* was issued in February 2009. This study indicated that, although progress had been made, several unresolved issues remain. In the final phase of this

IFAC Project on Business Reporting

project, the project group has interviewed 25 key leaders from around the globe on what should be done to improve these areas.

Over the next months, the interviews, including overviews of the recommendations, will be available on the IFAC website, grouped in the following themes:

- Good governance and sustainability fundamental for improved business reporting (issued in June 2010)
- Business reporting beyond the crisis: how to make sure that we don't tumble into another black hole (issued in July 2010)
- Business reporting through the lens of the investor (issued in August 2010)
- A global language for business reporting
- Towards a broader view of business reporting

Subsequently, the project group will develop an action plan, based on the recommendations of the interviewees and taking into account the reader response.

* *The project group consists of Charles Tilley (Chief Executive Officer of CIMA and Project Chair), Graham Ward (Senior Partner at PricewaterhouseCoopers and past IFAC President), Norman Lyle (retired Group Finance Director of Jardine Matheson Holdings Limited and Chair of IFAC's previous Financial Reporting Supply Chain Project), and Al Anderson (Managing Principal—Accounting and Assurance Services of Larson Allen and Chair of the Assurance Services Executive Committee of the AICPA). The steering group is assisted by Stathis Gould and Vincent Tophoff (both IFAC), and Amy Pawlicki (AICPA).*

Premise of financial reporting

"If you are reporting on a business, you need consensus between the corporation and the investor community to determine what is relevant and what is not," says Mr. Madrazo. Ms. Branwhite makes a start: "In my view, the very basic premise of financial reporting is to provide an unbiased, complete, and well-informed view of the financial performance of a business, based on a well-defined set of standards, which are used consistently across a whole range of companies." According to Mr. Waldron, disclosures are relevant to financial statements, emphasizing that they should be "prepared in a high-quality manner."

Complexity of financial reporting

Respondents to IFAC's previous studies from March 2008 identified complexity as one of the main difficulties in financial reporting. According to interviewees, complexity continues to pose a challenge. Ms. Branwhite says, "Things like off-balance sheet accounting, warehousing of financial instruments, mark-to-market valuation, and all those other issues that made financial information so opaque have increased the complexity of financial accounts such that it has become difficult for many investors to trace the financial performance of a business." She warns that "if financial accounts are not prepared with the users in mind, then we risk a whole area of unaudited 'shadow reporting' being provided directly to investors that doesn't go through the rigorous financial accounting process." Mr. McKersie adds, "If complexity is masking real issues, however, that is a real concern because that might result in less confidence. Therefore," he says, "companies should genuinely try to produce financial accounts that are informative. In our opinion, this is a better way forward than introducing new regulations."

Information overload

"Investors don't necessarily think bulkiness is an issue as long as can they can find what they need," says Mr. McKersie. Ms. Branwhite concurs, indicating that reports are long by necessity: "As the accounting standards themselves have gotten more complex, analysts have needed more information to understand the numbers that they are looking at. Hence, you then end up with about 400 pages in financial reporting, so that analysts are able to peel back that information." Mr. Waldron adds: "We hear frequently from preparers who say that the expanded disclosures aren't used by investors. Yet when we go to roundtables or in other forums, investors frequently ask for more quantitative and qualitative disclosures."

The interviewees realize though that an overload of detailed information provides a problem for retail investors, many of whom lack the financial expertise or the time for proper analysis. One solution might be to engage third parties. "We work with banks that market to retail investors via their branches throughout the country. These retail brokers receive exactly the same presentation as do larger, institutional investors," says Mr. Madrazo. Ms. Branwhite explains, "Part of our job is to help the wider investor base to better understand what is happening."

Fair value

"Fair value accounting is very important," says Mr. Webb, "certainly on the fixed assets side, because we need comparability between companies in a sector, between companies in a market, and between companies in different markets." Mr. Waldron also strongly favors fair value. In fact, he "believes that it is the most decision-useful measurement basis for investors." Mr. McKersie notes that "fair value is without doubt of interest for investors," but that "the reliability of these fair value measurements" is important for investors to consider. According to Mr. Waldron, however, "Investors feel that relevance has primacy over reliability, so combining high-quality disclosures with the fair values presented in the financial statements presents more decision-useful information."

Direct cash flow method

According to the interviewees, the direct cash flow method might help (retail) investors better understand the performance of a company. Mr. Madrazo recommends that "standard setters and regulators … better distinguish the impact on earnings that results from changes in fair value, versus those changes that we see from the day-to-day running of the business." There is merit to the use of a direct cash flow statement, according to Ms. Branwhite, "because the wider investor community will be able to see more clearly the operating performance of the business, the investing decisions being made by the business, as well as how the business is being financed and any changes in the value of the assets and liabilities." According to CFA Institute's Comprehensive Business Reporting Model, "The cash flow statement provides information essential to the analysis of a company."

International convergence of accounting standards

"International convergence of accounting standards is valuable and desirable because it increases international comparability," says Mr. McKersie. Mr. Waldron agrees: "We believe that the global capital markets would be best served if accounting standards in jurisdictions around the world evolved to a point where there was one set of high-quality, understandable reporting standards. This would enhance comparability and analysis of investment opportunities globally." International convergence to one set of accounting standards would also benefit multinational corporations, as Mr. Madrazo makes clear: "Like any other Latin American company listed in the US, Televisa must comply not only with our own local rules but also with US rules. This is a very time-consuming task."

Although convergence is admirable, it should not be attained at the expense of the quality. "The priority of both the US Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) should be to make the information in the accounts more relevant, reliable, transparent, and consistent," says Ms. Branwhite. "If convergence is not the outcome yet, we have not lost too much as long as those other quality criteria are met."

Management commentary

Additional disclosure, for example, in the form of management commentary, is desirable but still has a ways to go according to the interviewees. Mr. McKersie says "investors like directors to talk in good faith on how they see matters in order to make better quality investment decisions. Preparation of useful management commentary is an opportunity for the board to confirm that it is on top of what it is doing and the direction it is going." Mr. Webb agrees, but has some reservations: "If we had an independent election system for independent directors, then they would have more authority. In that case, I would favor giving them their own section of the annual report and an obligation to report any issues that they are concerned about, and any issues on which they have disagreed with the rest of the board."

Mr. Waldron sees gaps in the quantity versus the quality of information provided: "When companies include models, estimates, assumptions, principles applied, sensitivity analysis, and aggregated disclosures, they need to make sure that all of the qualitative factors, such as understandability, completeness, relevance, and comparability are considered." Ms. Branwhite recommends the use of key performance indicators (KPIs): "Knowing what management has set as its KPIs is critical information, as it provides an insight as to how aligned the company's long-term performance objectives are with those of its shareholders."

Sustainability reporting

The interviewees held mixed views on the usefulness of sustainability reporting. According to Mr. Madrazo, "Investors are increasingly seeking information on a company's environmental, social, and governance performance because they see these as indicators of good overall corporate management and often superior performance." Mr. Webb disagrees, saying, "Sustainability reporting is of no real value to investors. We shouldn't expect companies to try to make the world a better place at the expense of their shareholders." Instead, Mr. Webb sees a role for governments: "If everybody is required to clean up their waste, companies will economically price it into their products." Ms. Branwhite points out that "as there are going to be very clear financial implications on social and environmental aspects, they should become integrated into mainstream financial reporting."

IFAC supports the integration of sustainability reporting. IFAC's CEO Ian Ball will co-chair the newly formed International Integrated Reporting Committee (IIRC), whose objective is to create a globally accepted integrated reporting framework, bringing together financial, environmental, social, and governance information.

To read the complete interview transcripts, including summaries of interviewees' recommendations, see the IFAC website at www.ifac.org/frsc. Readers are encouraged to respond to the recommendations of the interviewees by completing a brief survey found at the conclusion of each interview transcript. For more information about IFAC's business reporting project, please contact Vincent Tophoff at VincentTophoff@IFAC.org.