

Narrative Reporting

Give yourself a head start*

the 1990s, the number of people in the UK who are aged 65 and over has increased from 10.5 million to 13.5 million (19.5% of the population).

There is a growing awareness of the need to address the needs of older people, and the Government has set out a strategy for the 21st century in the White Paper on *Ageing Better: The Government's Strategy for Older People* (Department of Health 1999). This strategy is based on the following principles:

- (i) older people should be able to live independently and actively in their own homes;
- (ii) older people should be able to live in their own communities and be able to take part in the life of their communities;
- (iii) older people should be able to live in good health and be able to take part in the life of their communities;

and the following objectives (Department of Health 1999, p. 10):

- (i) to ensure that older people are able to live in their own homes and communities;
- (ii) to ensure that older people are able to live in good health and be able to take part in the life of their communities;
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Give yourself a head start

For those who embrace these demands rather than shy away from them, the opportunity exists to use them as a basis for creating real competitive advantage

In recent years there has been much tinkering with accounting and financial reporting standards. But surveys of analysts and investors across the globe indicate that current models are still too backward-looking and compliance-driven. Put simply, they aren't delivering the information analysts and investors need.

This has been a cornerstone of the debate surrounding the reporting model for over a decade and the reason behind the increasing demand for narrative reporting to better explain the quality and sustainability of corporate performance. However, companies often bemoan the fact that they barely have time to actually run their business due to the increasing mountain of regulatory and legislative demands being made of them.

Under such pressure, it is not surprising that companies often adopt a narrow response to demands for narrative reporting. However, they are actually focused as much on how businesses are run, as on reporting. For those who embrace these demands, rather than shy away from them, the opportunity exists to use them as a basis for creating real competitive advantage.

Narrative reporting offers a mechanism to support the creation of a more commercially attractive and differentiated picture of the business which can lead to better investor understanding and improved stakeholder relationships. Furthermore, the underlying process necessary to produce this information can also enhance Board effectiveness and improve governance.

Forward-looking companies are already seeking ways to turn these demands from a burden into an opportunity. However, if these opportunities are not grasped and the process is not planned adequately, businesses run the risk of damaging their reputation among stakeholders, their market rating and ultimately their competitive positioning; never mind the risk of legal and regulatory challenges.

So how can companies identify and maximise the opportunity this information provides while ensuring the risks are managed? At PricewaterhouseCoopers, we have used our expertise to create this essential guide to narrative reporting in order to help companies meet the demands and enable them to generate the benefits. The task of realising the opportunities needs time and effort, but our 10 point plan provides clear guidance on where this should be directed.

Companies are facing ever-increasing demands for narrative reporting and the sooner they start to prepare for it, the better positioned they will be to avoid the pitfalls and reap the benefits – act now and the benefits are there for the taking!

A note on terminology: narrative reporting

Throughout this publication we use the term 'narrative reporting' to relate to the critical contextual and non-financial information that is reported alongside financial information so as to provide a broader more meaningful understanding of a company's business, its market position, strategy, performance and future prospects - including quantified metrics.

Narrative reporting in a nutshell

A summary of legislation and guidance on narrative reporting

For a decade, or more there has been ongoing debate globally around the scope and quality of information in corporate reports. In response, as Exhibit 1 illustrates, legislation and guidance encouraging companies to report a broader set of information has evolved.

These regulations and guidance encourage companies to reveal just what information they rely on to manage their business. Some of this information may already be reported, but not necessarily in the annual report, whilst other information may currently be used internally, but not reported. If this is the case, companies will need to assess whether the information is considered robust enough to disclose publicly. At the extreme, a review of the information-set available to understand strategic progress may highlight information that is missing. In this situation, companies will need to consider how to close the information gap(s) that exist

and how to improve the nature and quality of information used to manage the business.

Throughout this publication we consistently refer to the broader information set increasingly being demanded in annual reports. This delivery vehicle was chosen because of its familiarity globally. However, as you go through this publication, we would encourage you to consider how the challenges faced and the observation and recommendations made are as applicable to any other medium a company chooses to communicate in.

Exhibit 1: Examples of guidance and legislation on narrative reporting

Guidance	
Global	
	IASB discussion paper on Management Commentary (published October 2005)
	International Organization of Securities Commissions (IOSCO) General Principles Regarding Disclosure of Management's Discussion and Analysis of Financial Condition and Results of Operations (published February 2003)
Territory	
Australia	
	Group of 100's Guide to review of operations and financial condition (published 1998, updated 2003)
Canada	
	CICA guidance on MD&A disclosure (published November 2002, updated May 2004)
United Kingdom	
	Accounting Standards Board Reporting Statement: Operating and Financial Review (published January 2006)
United States	
	SEC Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations (published December 2003)
Legislation	
European Union	
	Article 46 of EU 4th Directive and Article 36 of 7th Directive (published May 2004).

Companies will get out what they put in

The risk of ignoring the demands, the benefits of embracing them

Companies already provide a plethora of financial information in their annual report, and other communications medium, and support this information with varying degrees of detail around narrative and contextual information such as market dynamics, strategy and corporate social responsibility. Furthermore, by encouraging companies to provide information routinely used to manage their business, the guidance and legislation imply that the information should already be available. Surely with all the other pressures – reporting and otherwise - being placed upon companies, they can pay mere lip service to these demands for narrative reporting? The risks and benefits outlined below suggest they shouldn't.

Risks

These demands raise many risks for companies. Nevertheless the greatest of them lies in failing to adequately plan and respond to them – resulting in long-term damage to the company's investor relations, its reputation among stakeholders, its level of public trust, its market rating and ultimately its competitive positioning.

Information gaps may be identified too late in the process

Consideration of content at the last minute in the reporting process may highlight information gaps which cannot be addressed in the time available. Even if the content of a company's communication is comprehensive, it may have the effect of highlighting strategic and operational weaknesses in its business which could have been identified, and actions taken to address them, earlier in the process.

Competitors may achieve first mover advantage

The communication of narrative and contextual information will open up new areas of corporate reputation to scrutiny and debate. Failure to paint a convincing picture on this broad canvas will expose companies to unjustified comparisons and difficult questions from investors and other groups who monitor business performance on behalf of society.

If competitors gain first mover advantage they will be able to help shape the information demanded by these investors and other groups. Companies will then be encouraged, if not forced, to provide similar information, regardless of whether it is appropriate to their business model.

Failure to convey the right messages

By paying mere lip service to these demands companies may approach the communication of narrative and contextual information with a tick-box mentality, simply bolting on additional content without taking a step back and considering the messages conveyed. This can often result in missing information, mixed messages and a consequent misunderstanding by investors of what is important to strategic success or critical information becoming lost in the detail. If this occurs companies only have themselves to blame if investors misunderstand them.

Benefits

While narrative reporting can bring a number of risks there are also benefits for those companies who truly embrace the spirit of these new demands in a timely fashion.

Enhanced business understanding, improved governance and Board effectiveness

The process of responding to these demands can provide an opportunity for Boards' to question the depth and breadth of information they use and, as a result, assess whether the limited time available in Board meetings is being focused on the right issues. How many Boards routinely receive lead performance indicators that go beyond traditional financial numbers and how much time is devoted to strategy and activities critical to value creation? Over time, the challenge of responding to these demands will provide Boards' with a more comprehensive picture of corporate performance, one with new insights into the health and sustainability of the business.

Enhanced investor understanding and improved relationships with key stakeholders

A company with effective narrative reporting will give investors and other stakeholders' deeper and clearer insights into what really drives value in its business, and demonstrate clearly why its chosen strategy is the right one to take the business forward.

From PricewaterhouseCoopers ongoing engagement with investors it's clear that it's this broader picture and its completeness and cohesion that underpins their view of management's' quality. Among other advantages this will enable companies to improve its reputation and market rating, lower its cost of capital, and attract and retain the best talent.

Aligned reporting and communication strategy

Corporate reporting is going through a period of unprecedented change. As reported earnings become more volatile, corporate governance guidelines become more extensive, and socially-responsible investment indices become more challenging, the discipline of reporting narrative and contextual information consistently over time and across mediums offers companies a framework for providing insights into their underlying performance.

Internally the challenge of collating a coherent set of narrative and contextual information provides companies with an opportunity to reassess the practical aspects of how information is channelled into the outside world both in terms of the messages being given, but also the costs incurred by various groups (from corporate communications, investor relations, environmental and social reporting, employee communications etc).

What are the challenges?

The key implementation challenges companies will face

The increasing demand for narrative reporting has implications both internally and externally for companies. Internally, the information increasingly being demanded will necessitate that companies challenge the degree to which they have robust and timely processes capable of collecting, validating and reporting a wide variety of information on a timely basis, some of which may not have been collated, or reported externally before. Externally, it will shift the relationship with shareholders and other stakeholders onto an entirely new footing – one in which the transparency and credibility of a company’s strategy and management actions will become a key competitive differentiator.

A cohesive team

Do you know which “information owners” should have input into developing a broader information set?

The annual report has traditionally been the domain of the CFO and finance team. Given the breadth of information increasingly being encouraged, it will now require the input of a number of other key individuals and teams to make it happen. From those involved in strategy, to those involved in human resources, R&D, customers, brands and marketing and the environment.

The challenge for companies will be to connect these various “information owners” with potentially competing agendas and to manage their expectations as the overall structure and content of the annual report is developed and finalised. Only in this way will a fully integrated and coherent annual report be produced.

Meeting investor needs

Do you understand what information your investors need?

Companies will need to exercise much greater judgement than historically to determine what information investors need to assess the strategies adopted and the potential for those strategies to succeed. They will also need to consider the extent to which issues relevant to other stakeholders (such as: customers; suppliers; employees; and the wider society) are also of significance to investors, because of their influence on performance and value creation.

But what exactly are the needs of investors and the issues affecting other stakeholders? Have they been asked? Understanding their reaction to the last analyst presentation may not be enough. Do competitors have a better understanding of, and response to, these needs or issues? It is vital that companies understand from the outset what investor needs are if they are to be appropriately addressed and peers aren’t given the opportunity to steal a march and extract competitive advantage.

A picture of sustainable value

Do you understand what actions drive sustainable value in your business and can you articulate this?

Companies are increasingly being encouraged to identify, quantify and report publicly on the areas of their business which drive sustainable value – both financial and non-financial. This presents the challenge of whether they truly understand how the effective management of their risks, resources and relationships actually creates value in their business and whether they can articulate this?

Companies should therefore consider to what extent information relating to key relationships (e.g. customers and suppliers), brands, innovation, employees, suppliers and social

and environmental issues are important in evaluating strategy and performance. Furthermore, they will need to consider whether robust, quantifiable financial and non-financial key performance indicators are available to support assertions made in respect of this information.

A review of the internal information-set may identify gaps in the information available for disclosure. Companies will need to consider the extent to which the gaps need addressing in order to present a coherent picture of sustainable value.

Information used to manage the business

Are you comfortable enough with the robustness of the information to place it in the public domain?

Most companies will already have systems and procedures in place to produce information which enables them to determine and manage the risks to achieving strategic success, and to assess and challenge performance against strategic objectives. But, critically, some of this information may have never been reported externally before which raises two important questions:

a) How relevant is the information?

The appropriate areas to be covered may differ for every industry and for each company within an industry. The ability for a generic template to be developed which companies may usefully apply as an input into their annual report development process will therefore be limited to an industry level at best. Accordingly companies may consider meeting with competitors to form consortia to help develop and define appropriate industry key performance indicators and agree on how information should be reported.

Other guidance on what to report and how best to structure it may be sought from examples of good reporting practice from companies in the same industry, or indeed, other industries.

b) How reliable is the information?

Companies will have to decide whether they feel comfortable enough with the reliability of the information to place it in the public domain. The information presented should be the information Boards' use to manage their business. Accordingly, what gets reported externally should be the output of a formalised process, both in the determination of the shape and nature of the content and in the actual production of the information itself. Companies will therefore need to consider whether, or not, the information to be disclosed is derived from established processes, is sufficiently reliable and has been subject to adequate controls, Board scrutiny and governance.

Clearly, in determining what information to report there may need to be a trade-off between relevance and reliability.

Structure and coherence

Have you considered the impact of this broader information set on the overall structure and content of your annual report?

Current reporting of strategy is not something many companies typically do well. When reporting is extended to an explanation of all the risks, resources and relationships that are critical to the successful implementation of business strategies and achievement of stated goals and objectives, there are even fewer examples of good practice.

The information increasingly being demanded challenges the traditional structure of an annual report. At present most annual reports primarily focus on reviewing historical financial performance whilst covering information on strategy, and the risks, resources and

relationships necessary to successfully implement the strategy in varying degrees of detail.

Companies will therefore have to consider how transparent they wish to be and what format their annual report takes. For example, do the Chairman and CEO continue to produce their statements separately from an operating and financial review, or equivalent section, potentially leading to excessive repetition? Or, will the whole of the front end of the annual report become a seamless section focusing on this broader information set?

Alignment and corporate consistency

Is your communication strategy fully integrated?

As companies reflect on the depth and breadth of information that might be included within their annual report and how it should be structured, they may identify that much of the information is already reported elsewhere; whether it be on the web site, in corporate responsibility reports or analyst/investor briefings.

Whilst not all information presented through these other media will be entirely relevant for the annual report, the presentation of a broader information set may provide companies with an opportunity for a review of their wider reporting and communication strategy.

The content in these other media used to communicate with a wider group of stakeholders may need to be reassessed for on-going relevance, in the light of this broader information set. Where information reported in the annual report continues to be presented through other channels there will be a need to ensure overall consistency of message.

What should companies be doing now?

10 key steps

to effective narrative reporting

- 1 Adopt the right mindset
- 2 Obtain Board sponsorship and buy-in
- 3 Develop a picture of possible content
- 4 Build a blueprint report
- 5 Benchmark the blueprint
- 6 Identify the information gaps
- 7 Assess adequacy of supporting systems and procedures
- 8 Determine the level of accuracy and reliability
- 9 Create cohesion and clarity
- 10 Develop an implementation plan

1 Adopt the right mindset

As with any demands for more information, there is a temptation to wait until they are directly affecting us before responding. The challenges, risks and benefits outlined earlier should persuade companies that delaying their response could well be a serious error – not least because the demands for a broader information set involves not just the way information is reported, but its reliability and the quality of the processes and controls supporting it.

Set out below are 10 key steps that companies may practically undertake to successfully respond to these demands while avoiding the pitfalls.

The first step lies in adopting what we have termed a ‘communication mindset’ – one that is quite distinct from the compliance-based approach usually taken with traditional financial reporting.

The communication mindset has three major components. It involves seeking out, ensuring there is sufficient comfort over the reliability of, and reporting information that is:

- seen through the eyes of the Board of Directors
- focused on matters that are important for investors
- forward-looking in its implications for the business

This approach, when applied consistently across all areas of the business, will enable companies to produce an annual report which fulfils the demand for narrative reporting.

Companies will also need to consider the degree to which they respond to these demands. Will they be a leader, a follower, or simply take the middle ground? Given the risks and benefits highlighted earlier this is not a decision which should be taken lightly. The answer will not negate the need to follow the steps set out below, but it will impact the degree to which they are followed.

2 Obtain Board sponsorship and buy-in

Addressing these demands needs to be treated as a project in its own right, with sponsorship from a member of the Board and ownership clearly taken by the Board or a Board sub-committee. Whoever takes responsibility will need to oversee a planned and transparent process.

A first step should be to nominate an individual with responsibility for understanding the implications of these demands for the annual report’s development. This individual should then brief the Board on what the implications are for their company.

It will also be important at this stage to identify the relevant “information owners” who may be required to contribute to the annual report. Some individuals may not have contributed to it, or worked together, before, some may have alternative agendas. It is therefore important that this individual should be of sufficient authority to manage the variety of influences and personalities which may exist among the contributors.

The breadth of information provided in the annual report will also require a new approach at Board level if an integrated response to issues is to be generated. Companies will need to access a broad range of skills and knowledge in order to filter and challenge every item of information, not just for its accuracy, but also for its relevance to their own decision-making and value creation. At the outset, the Board should determine whether they have the appropriate skill set, or whether they will need to obtain it from elsewhere (e.g. cross-functional advisory panels or external parties).

It is critical at this stage that companies debate and agree what it is they’re trying to achieve, their expectations and level of ambition for the annual report and how transparent they wish to be. Furthermore they need to express their views on the importance and relevance of information, financial and non-financial, up front so as to avoid wasted time and effort.

3 Develop a picture of possible content

Having formed a view on the level of ambition, companies should consider applying an objective framework, such as Kaplan and Norton's Balanced Scorecard or PricewaterhouseCoopers Corporate Reporting framework (see Exhibit 2 on page 16), as a basis for developing a broad picture of possible content for the annual report. However, it will need to be tailored to reflect the unique dynamics of their industry and business. A number of sources of information

internally may be applied in building this broad picture, including the corporate risk matrix, stakeholder surveys, monthly Board reports, analyst presentations and corporate responsibility report.

Having created this picture, it may be necessary to question again whether the right individuals are involved in the development of the annual report.

4 Build a blueprint report

Having built a picture of the broad set of information which may be included within an annual report, the next step is to calibrate the content by applying a strategy filter to determine what information is critical to assess the existing strategy and the potential for that strategy to succeed. This filtered picture should then act as the blueprint against which the content of the annual

report being developed should be constantly compared and challenged.

The blueprint should not be a static tool, but something which can be flexed to accommodate changes in companies' circumstances and developments in the availability of internal information.

5 Benchmark the blueprint

The blueprint should now be compared against the information currently reported externally. In performing such a comparison companies should take into account all mediums of communication used to report information internally and externally, including web site, corporate responsibility report, investor/analyst briefings and marketing publications.

In building up a comprehensive picture of current reporting, consideration should also be given to assessing where companies stand in relation to competitors, industry norms and good practice and the extent to which they wish to align themselves with these benchmarks.

6 Identify the information gaps

An output from the benchmarking exercise should be an analysis of the gaps between current reporting, competitors and the broader information set required for the annual report. Some gaps may simply point to information which is available, but not reported. Other gaps may relate to more fundamental issues such as data quality, or where information is simply not produced within the existing systems or consistently across business units. This is considered further below.

Creating a gap analysis will be very revealing and should provide the basis for developing an implementation plan for both the short and the medium term. It is critically important to remember the development of an annual report is an evolutionary process, not one of immediate revolution.

7 Assess adequacy of supporting systems and procedures

Once the blueprint has been developed, an assessment of the supporting systems and procedures should be undertaken to determine whether they can provide the relevant information and whether it is sufficiently robust to achieve Board comfort and publish externally. A useful first step is to start at the top of the organisation and consider the scope, and nature, of the information being presented to the Board in routine meetings, and the degree of process, control and assurance applied to it in its journey up the organisation.

Where this analysis highlights shortcomings consideration should be given to the actions which are necessary to remedy the situation, ranging from rethinking the Board agenda, to establishing robust and reliable systems and controls.

Questions which companies may like to consider include:

- Is standard group-wide information available?
- Is there sufficient transparency in areas of judgement?
- Are systems in place to gather financial and non-financial information?
- Is both qualitative and quantitative information available and is it sufficiently developed?
- Are there appropriate key performance indicators and other measures to support all strategic drivers and are they consistently calculated?
- What degree of segmental information will have to be provided to make the data meaningful?
- Who is routinely challenging and vetting the information?

8 Determine the level of accuracy and reliability

Companies must determine the level of accuracy and reliability they wish to achieve for the information to be included within the annual report. This may vary depending on the strategic importance, nature, or source of the different information provided. In forming a view, companies must balance the risk of publishing valuable information, which may be difficult to obtain with complete accuracy, with remaining silent.

Factors to consider include:

- whether the data is routinely used in the management of the business and is subject to sufficient challenge and validation
- whether a greater level of assurance is required for non-system generated information/data (e.g. spreadsheets or stand-alone analyses)

- whether external sources of data can be used and referred to, to support the overall picture of performance
- the degree to which some information necessitates the involvement of internal audit or independent third party assurance

In reaching a decision it will also be important to consider the margin of error companies are willing to accept and to what extent that might differ depending on the nature of the information reported.

9 Create cohesion and clarity

Narrative reporting provides a real opportunity for companies to consider what impact it will have on the existing structure of the annual report. Will the historical format traditionally used allow for the effective communication of the company’s strategy, management activity and performance? Or will it simply result in excessive repetition, increased length and an unclear story?

Two extremes which companies might consider are:

- use the traditional format of Chairman’s/CEO statement and financial review but wrap the whole front end of the report under the umbrella of an Operating and Financial Review – or similar term.

- radically restructure the front end of the report around a logical framework which helps to tell a clear and coherent story

Each has their pros and cons. We strongly believe, however, that the report should be personalised and that this can be achieved without necessarily following the traditional model. The approach taken will ultimately depend on the culture of each company, the depth and breadth of information available and above all, the leadership provided by the Board.

10 Develop an implementation plan

Following steps 1 to 9, companies will be in a position to develop a short/medium-term implementation plan to address the gaps identified and deliver on their overall objective for the annual report.

For information that is currently unavailable companies need to consider whether to seek to obtain the information and, if so, to provide disclosure of their intent to report on these matters in future reporting cycles.

For information that is available, but not sufficiently robust and comparable to publish, companies must determine how they obtain the appropriate level of comfort on the reliability of the information. This may range from the development of new internal controls and processes to independent verification.

Exhibit 2: The Corporate Reporting Framework

Our ongoing global industry research with more than 3,000 CFOs, investors and analysts focuses on determining what information is of particular value in managing an entity (management’s view) and assessing an entity for investment purposes (investors view).

This research has highlighted that these two seemingly disparate requirements can be largely addressed using a single information set. We have codified these findings into the four building blocks of the Corporate Reporting framework shown below. The first category of information investors need is an analysis of the economic and competitive landscape of the company, followed by an articulation of the strategy and structure required to compete within this

landscape. Next comes the competencies, relationships and resources that will enable the company to achieve its strategy. Last but not least are the financial and non-financial outcomes of their corporate activity.

Here we present a generic framework, but in reality it can be tailored to reflect the findings from each of our global industry surveys. By applying the framework, companies will be able to address the critical components of the narrative and contextual information being increasingly demanded. Its logical structure can assist them in providing a clear link between business objectives and strategy, the critical components of performance that will affect whether these strategies

succeed and shareholders’ understanding of business risk and how value is created.

Furthermore the focus of the annual report should be on the quality, not quantity, of information. By placing strategy at the heart of the annual report, companies should identify only those risks and resources critical to understanding its execution and potential to succeed. Applying a framework tailored to meet the key information needs of investors and management in a given industry, means companies avoid falling into the trap of the ‘checklist’ approach to developing content, which usually results in reporting excessive and often unnecessary information.



Process of evolution, not revolution

Recognition that change will not happen overnight

The challenge should not be underestimated

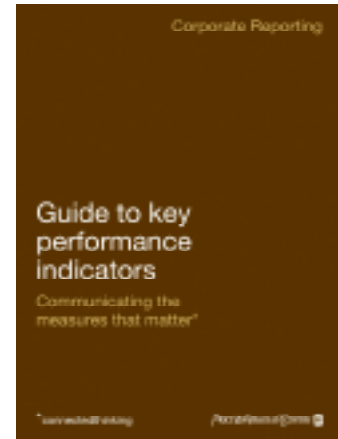
Whilst companies are facing increasing demands for narrative reporting the breadth and depth of information provided in the annual report cannot change over night. The development of such a picture should therefore be seen as a process of evolution, not revolution.

However, the challenge to some companies should not be underestimated. Information may need to be captured and its reliability challenged. Or, if information does not exist, reporting systems may need to be enhanced. Critically, information should not be reported unless it is used to routinely manage the business.

Companies should also constantly reassess the nature and scope of what is being reported against their blueprint, the actions of their competitors and other external developments. There will be an expectation that the information provided in an annual report will need to be consistent over time. Yet the content cannot remain static as information needs will shift as a result of changes in the business, its strategy and risk profile, and the overall market environment in which it operates.

The demand for narrative reporting is growing; there is no time to lose. The sooner companies start to prepare for it, the better positioned they will be to avoid the possible pitfalls (e.g. competitor pressure, regulatory challenges, unreliable and incomplete data) – and reap the potential benefits (e.g. competitive advantage, improved board effectiveness, enhanced investor understanding).

Other Narrative reporting publications



Report Leadership

Report leadership is a multi-stakeholder group that aims to challenge established thinking on narrative reporting. The contributors to this initiative are the Chartered Institute of Management Accounts (CIMA), PricewaterhouseCoopers LLP, Radley Yeldar and Tomkins plc.

You can help shape how the Report Leadership project evolves by giving your comments, actively participating, or adopting the elements that appeal to you.

Please give your feedback, register your interest, and keep up to date with developments at www.reportleadership.com.

Contact us

For more information on the implications of evolving narrative reporting practices, both internally and externally, and to obtain copies of our publications please send an email to info@corporatereporting.com or visit our website www.corporatereporting.com

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