Annual Reports: an Opportunity Lost?

by Peter Parry

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I recently attended an event organised by the Audit Committee Chairs Independent Forum (ACCIF). The objective was to bring together investors and audit committee chairs to talk about improving and increasing the dialogue between them. The event was chaired by Jim Pettigrew, President of the Institute of Chartered Accountants of Scotland. He was joined on the stage by a panel of five speakers. Unfortunately, we were not told in advance who the speakers were. It only became clear when each one gave their introductory talk that they included Jock Lennox, the ACCIF Chairman as well as representatives from Legal and General, the FRC and two audit committee chairs. The introductions from the panel members were followed by a question and answer session from the floor.

Answering questions that nobody asked

The introductory session included a summary of the main findings from a survey that the ACCIF had recently carried out with its members. This indicated that committee chairs thought that investors should be paying close attention to the sections of the annual report covering:

The strategic report

Principal risk disclosure

The critical judgements and key estimates used.

There was debate about the extent to which investors ever contacted audit committee chairs to discuss any of these issues. Two audit committee chairs said that they had never received a request from an investor to meet to discuss anything in the annual report. Some of the investors in the audience confirmed that if they wanted to discuss anything in the annual report they would approach the company Chairman, the CEO or the CFO but probably not the chair of the audit committee.

The chairman of the meeting struggled to find a way out of the blind alleys down which this line of debate seemed to lead. The audience listened politely but many must have wondered whether their time was being well-spent.

The trouble with the annual report

Gradually, the debate did come to life. Jock Lennox, the ACCIF Chairman, commented that:

Much of the content of the Annual report was impenetrable;

There was no effective 'feedback loop' for audit chairs to know whether information in the annual report was useful to investors;

Innovative ideas were needed to make annual reports easier to use; some information could be condensed while the way in which related topics were linked and made easily accessible to users needed to be considered.

A representative from the Investment Association commented that often issues were not reported because the company refused to allow it. She did not say exactly what she meant by this but someone noted that the strategic report often gave little useful information for investors – particularly in providing meaningful context in which investors could judge the principle risks that the company was disclosing. The reason for this, retorted one of the institutional investors, was because company strategy was commercially sensitive and therefore confidential. This received a sharp rebuke from a committee chair who commented that in reality it was very difficult and rarely appropriate for one business to copy another's strategy. Close rivals probably knew each other's strategy anyway. Using confidentiality as a smokescreen for withholding information rarely stood up to scrutiny. There was clearly food for thought here!

There were comments also on the reporting of the business model. One of Warren Buffet's investment principles is 'If you don't understand the business don't invest in it.' Research by the FRC for its Reporting Lab project has shown that the way many companies articulate and explain their business model in the annual report is dreadful. In some cases you wonder if the directors understand their own business model. The problem is that without a coherent explanation of the business model how can you assess statements about the business strategy, principle risks, company culture (currently a hot topic of debate for reporting) or critical judgements that the directors have made?

Conclusions

Plenty of work is going on to try and ensure that the annual report becomes a more useful document for investors in future and that it gives an accurate picture of the company, the way it operates and its performance. Inextricably linked to this is the annual audit. Following the financial crash this dark, dry, dusty corner of reporting which has traditionally been seen as a formality is now very much in the spotlight. For the first time in over sixty years it looks as if it will undergo seismic change that will benefit investors. Let's hope so and let's hope that it doesn't degenerate into an exercise in adding more banal content that meets a compliance need and nothing else. From what I have seen, I am hopeful that meaningful change is on the way.

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