

What are narrative reports accounting essay

[Business](#), [Accounting](#)



1. 0 Introduction

In recent years, the nature of business has changed fundamentally. Due to the recent global financial crisis, regulators and businesses have realised that the financial reporting system today is no longer sustainable. However, some of the companies have collapsed in the past even though they had extensive regulatory and reporting standards (ACCA, 2011). Rowbottom and Lymer (2010) stated that the provision of narrative reporting information responds to concerns from user groups that annual reports and particularly financial statements do not provide sufficient information to enable them to understand the performance and position of modern companies. Smith, Dong and Ren (2011) claimed that Narrative disclosures have become " longer and more sophisticated" over the past decades, and stressed that the purposes of narrative disclosures is to provide useful information to aid the third party in their decision making and promote a meaningful report. On the other hand, management commentary is a narrative report that relates to IFRS compliant financial statements, it provides users with historical explanations of the entity's financial position, financial performance and cash flows as well as commentary on an entity's prospects, objectives, strategies, targets and other forward-looking information (IFRS, 2010). Beattie, McInnes and Fearnley (2004) mentioned that in order to serve the information needs by various users and promote corporate transparency and accountability, the reporting model needs to expand beyond the traditional financial reporting model which deem to be backward-looking and only provides quantified information. On the other hand, compared with financial disclosures, narrative disclosures contain complementary and incremental information.

The limitation of the financial statement is that the information is obtained from the past and deemed to be irrelevant to be use by the users for future decision making. Among the information that the users need to have in order to make future investment decisions are information which related to corporate " future" information, such as " the firm's perception of the importance of economic and industry-specific factors (Smith, Dong and Ren, 2011). Today, businesses have used narrative reporting to close the gap between statutory reporting and the information needs of stakeholders. Narrative reporting provides a unique opportunity for businesses to disclose its relationships with stakeholders and to provide environmental and social responsibility (Aribi and Gao, 2012). In the other aspect, Smith, Dong and Ren (2011) report has also found out that the narrative discourse quality is positively correlated with the corporate performance where a good financial performance is associated with a clear Chairman's Statement narrative, which is reflected by high level of readability. The use of management accounting systems with narrative reporting has been increasing in the last few years that improved management accounting systems' information in light of the changes taking place in the business environment (Halbouni and Hassan, 2012). WeiBenberger and Angelkort (2011) mentioned that internal and financial performance measures are easily reconciled on all hierarchy levels, providing management as well as investors with " one version of the truth" (p. 161). In the current business environment, managers need relevant " management accounting" information in order to make value-adding decisions. (Halbouni and Hassan, 2012). On the other hand, Arvidsson (2011) describes that Managers need detailed information about their part of

the organization, in order to cater to their needs; management accounting provides detailed information tailored for specific users.

2.0 What are narrative reports?

Recently, the International Accounting Standards Board (IASB) issued an important discussion paper on ' Management Commentary'. This discussion paper has now been followed by an exposure draft which defines management commentary as follows:" A narrative report that relates to financial statements that have been prepared in accordance with IFRSs. Narrative reports provides users with historical explanations of the amounts presented in the financial statements, specifically the entity's financial position, financial performance and cash flows. It also provides commentary on an entity's prospects and other information not presented in the financial statements. Narrative reports also serve as a basis for understanding management's objectives and its strategies for achieving those objectives." (Fraser, et al., 2010, p. iv). The management commentary is intended to be a narrative report that provides a context for the financial statements by interpreting the financial position, performance and cash flows of an entity, as well as explaining its objectives and strategies for the future. Many jurisdictions already use similar narrative reports which are sometimes described as management's discussion and analysis (MD&A), operating and financial review (OFR), business review or management's report (IFRS, 2010). In addition to the audited financial statements and notes, there are certain section which is heavily subject to regulatory requirements such as the auditor's report, the directors' report, corporate governance statements, directors' remuneration reports, tables of contents, information for

shareholders, historical summary tables and lists of principal operating companies. The material remaining, therefore, includes highlights, chairman's statement, CEO's review, OFR, people, community, directors and advisors and captions from pictorial material (Beattie, McInnes and Fearnley, 2004).

2. 1 Supplement and Complement Information

The narrative report should be consistent with the standard of supplement and complement information in the financial statements by including prospective and retrospective information in a series of major issues, including the business model, strategy and structure, customers, human resources, innovation, brands, intellectual assets, supply chain, economic performance, business performance, environmental, social and ethical performance, risk and uncertainties, as well as corporate governance (Sajjad, n. d.). Furthermore, they will need to consider whether robust, quantifiable financial and non-financial key performance indicators are able to support assertions made with regard to this information (PWC, 2007).

2. 2 Exposure draft

The emphasis given to narrative disclosure in corporate reporting, has greatly increased in recent years. This has caused a discussion paper to be issued, followed by an exposure draft, prepared by the IASB to address the management commentary sections of the annual report, in other words, the narrative sections accompanying the company's financial statements. The two documents represent two stages in the production of an international standard for narrative reporting, and include clauses on disclosures of

qualitative risk and business forecast information (ACCA, 2011). On the other hand, many respondents to the exposure draft were concerned about the focus on forward-looking information. However, the Board decided that forward-looking information is important. Explanations of management's perspective of the entity's direction, targets and prospects, in addition to explanations of past events, can help users of the financial reports to develop expectations about the entity from its past performance and current state (IFRS, 2010). Nevertheless, the Board decided not to include such detailed guidance because there is a risk that undue emphasis could be placed on the application guidance or illustrative examples. Furthermore, the Board observed that such guidance or examples could be misinterpreted and thus reduce the flexibility in applying the framework. Many respondents to the exposure draft supported the Board's decision not to include detailed application guidance or illustrative examples (IFRS, 2010).

3.0 Recent development of narrative reporting

A study by Sajjad (n. d.) claims that the recent debate on usefulness of narrative reporting has focused on whether corporate reports provide sufficient information to users of annual reports to make an objective decision about the business models. As the business model is, to put it simply, a way of doing business, disclosure would have a pervasive effect on all aspects of a business's operations: the competitive and legal environment in which it operates, its place in the supply chain, the nature and level of its engagement with key stakeholders, the quality of its board of management, its commitment to sustainable development, and the actual products and services it delivers. Business model disclosure could offer retrospective but

more importantly prospective decision influencing information by explaining the infrastructure, the networks, the resources that drive the strategic direction, the business differentiators and value drivers, the implementation of the unique value proposition, the profit margins, the cash flows, and the associated internal and external risks. On the other hand, narrative reporting is an opportunity for the management to explain its objectives, and strategies for achieving those objectives, by providing a context within which to interpret the financial position, financial performance and cash flows of an entity. It identifies the provision of decision useful information to current and potential investors as the principal characteristic of narrative reporting (Sajjad, n. d.). A quantified, evidenced, future oriented, cohesive, balanced and relevant narrative report facilitates an understanding of the businesses model of a company. It should enhance the relevance of corporate reports while at the same time nurturing trust between the preparers and users of annual reports and so in theory should be instrumental in developing and maintaining corporate reputation (Sajjad, n. d.).

3. 1 Public relations function

The scale of annual corporate reports issued by companies and other organisations has seen increasing in the past century. At the same time, the nature of report content has evolved continuously. Voluntary disclosures increased greatly as corporate reports increasingly became a public relations function. In particular, the burgeoning corporate social reporting (CSR) agenda was a major theme underpinning the voluntary disclosure growth towards the possible development of a broader reporting paradigm (Fraser, et al., 2010).

3. 2 Governance and board effectiveness

Furthermore, the related process require to produce this information can improve the board effectiveness and to improve governance. Although narrative reporting can bring a certain degree of risks but also benefits for those companies who truly embrace the spirit of these new demands in a timely fashion. Improved the understanding of the business, improved governance and Board effectiveness, the process of responding to these demands can provide an opportunity for Boards' to question the difficult of information they use, therefore, to assess whether the limited period of 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 (PWC, 2007).

4. 0 Challenges faced by companies

The increasing demand for narrative reporting has an implication towards companies internally and externally. The internal implication that the company might face is that the company might face an increase in demand which will caused the company to have issues in terms of collecting, validating and reporting a wide variety of information on a timely basis as they need to determine which information need to be reported and which is not (PWC, 2007). As for external implication, the company will face a shift in relationship with their shareholders and other stakeholders into an entirely

new level, in which the transparency and credibility of a company's strategy and management actions will become a key competitive differentiator. Due to this companies may need to exercise more judgement rather than relying on historical data . For example, instead of using historical data, the company need to determine what relevant information that they should provide to the third party in order for them to make investment decision wisely (as in the company may want to provide access to the investors regarding on their strategies and future plan to ensure sustainability) (PWC, 2007). On the other hand, companies have been encouraged to identify, quantify and report publicly on the areas of their business which drive sustainable value. As a result of this, all companies should consider at 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 (PWC, 2007).

4. 1 Unnecessary immaterial clutter

Yeoh (2010) stated that the use of narrative reporting have caused an expansion in the corporate annual reports from its previous volume of not more than a dozen pages to its current form of a few hundred pages . He further elaborate that the length of corporate annual reports increased by 48 per cent from 2005 to 2009 after the narrative report has been included. Investors do not read audited financial information as it is deemed to be more complex and it makes them become more unreliable. This shows that

the increased volume and complexity of financial statement data can lead to information overload and may deter some users such as investors (Rowbottom and Lymer, 2010). Hence, narrative reports that contain all complex financial statement data may be more useful to private shareholders and other stakeholders who lack the tools, expertise and resources needed to interpret that data. Rowbottom and Lymer (2010) found that employees use narrative information to understand the business and appraise employment prospects while lacking an understanding of complex financial statements. Smith, Dong and Ren (2011) found that some companies may prevent readers from gaining a thorough understanding of corporate reality by putting unnecessary jargon in the annual report, which will complicate its readers. Besides that, a company which is poorly performed also may use a skillfully crafted writing style to make the report looks more complex and difficult to understand and read to distract readers to gain some understanding on the company performance. However, Fraser, et al., (2010) explained that users perceive the narrative reports to be a useful; while at the same time, several factors, such as the use of ' boilerplate' language and the fear of being held accountable for unrealised predictions, are perceived to reduce its usefulness.

4. 2 Reliability of Narrative Reports

The reliability of narrative reports has been a persistent concern. Unaudited narrative reports have been criticised as self serving, overly optimistic accounts of business performance and position. Due to this, the reliability of narrative reports can only be enhanced with the presence of an external auditor opinion. While statutory financial statements are externally audited,

the lack of verification of narrative reporting will tactically raise issue regarding on the transparency of disclosure. As the financial statements preparation is governed by IASB standards, the lack of clear guidelines on how narrative reporting should be conducted has cause fears over reliability of disclosure (Sajjad, n. d.). According to study conducted by Fraser, et al., (2010), investors believe that it would be acceptable if the company could provide some external assurance on the narrative reports. This is to promote transparency on every disclosure that the company made on the report. The perspective of professional investors, in general, is less enthusiastic than the average, possibly reflecting both a desire not to inhibit corporate style and content and scepticism about the capabilities of the existing external audit. In addition, some categories of expert users, perhaps analysts most obviously, have access to other information sources and have, therefore, they will not rely on the report that much. Fraser , et. al (2010) further elaborate that there is a high level of consensus across all users that current audit reports has not been that useful. In the other hand,, around 50% of the users believed that auditors should report on the adequacy of client risk management procedures and on the reliability of information throughout the entire annual report. For instance, on the more specific issue of narrative reports, this was generally perceived as useful although it was recognised that its usefulness could be limited by boilerplate language and the fear of being held accountable for unrealised predictions on the one hand and ' management spin' on the other. Therefore, investors believe that it is desirable that at least some level of external assurance is provided on

narrative reports, although they realised that creating assurance is difficulty (Fraser, et al., 2010).

5. 0 Research

A number of UK studies have explored the perceived usefulness of the narrative components of annual reports and the standard-setting approach adopted. A survey by Beattie and Pratt (2002) examined the preferences of expert users, private shareholders, finance directors and audit partners for disclosures in corporate narrative reports. Whilst all groups rated financial items such as operating income and earnings most highly, auditors favoured narrative reports-type information items, the authors reporting: "... audit partners, because of their role and responsibilities, find comparisons of current performance with benchmarks and information on sources of business risk particularly useful and it seems clear that auditors find MD&A information items very helpful in performing the analytical review process associated with the attest function." (Beattie and Pratt, 2002, p. 71)

6. 0 The future of Narrative Reporting

Many directions can be taken in the future research of examining the impact of voluntary disclosure on the informativeness of current returns. For instance, an analysis (e. g. interviews) that explores how investors apply voluntary information might provide an insight detail to us as to why voluntary information seems to be irrelevant in terms of its value (Banghoj and Plenborg, 2008). Other than that, the future of narrative disclosure of risks and business forecasts within annual reports is also unclear. It was mentioned in ACCA (2011) most research has found that, the narrative

sections of an annual report do not disclose enough useful information to enable the investors to make investment decisions. The quality and content of these narratives can be improved if there is more work and effort made (ACCA, 2011). It was mentioned in PWC (2007), most of the information in the annual report needs to be consistent over time. Although it has to be consistent, the content cannot remain in static position as the information needs varies from time to time as a result of changes in the business strategy, risk profile, and overall market environment. Slack and Shrivess (2010) have examined disclosure trends, causality of disclosure against business and sector influences, as well as theoretical development to help understand, explain and predict such disclosure. There has also been a growth in research examining the contents of other voluntary disclosure provided by companies in the chairman's statement and other business reviews.

7.0 Management Accounting System

CIMA believes that the usefulness of financial reports is greatly enhanced when the bare figures are supplemented with insightful narrative. They allow the company's financial story to be told through the eyes of management, helping to deepen investors' understanding the progress and position of the business. Management accountants typically play a major role in the presentation and interpretation of narrative reporting. On the contrary, management accounts are often considered too commercially sensitive to be published (CIMA, 2008). The content and presentation of management accounts is not prescribed by regulation, but by the need for clear, detailed information to support the management decision making (CIMA, 2008).

Another study done by Talha, Sallehuddin and Mohammad (2007) has brought up a serious argument where disseminating segmental information is likely to benefit existing competitors. Thus, such disclosure will put the reporting company into disadvantage. In the other hand, the lower compliance rate on segment reporting requirement has caused most of the managers concern as if the segment reporting is made, so they might lose a competitive edge against competitors. Other than that Talha, Sallehuddin and Mohammad (2007) also argue that preparing a segmental reporting may involve a huge amount of spending in terms of compilation, audit costs, and misinterpretation of the information by investors. As stated earlier, disclosing segmental information may result a company facing a competitive disadvantages. Competitive disadvantage can manifest itself in several ways such as political pressure, customer pressure and competitor's pressure. Besides that, competitive disadvantage may also serve as a deterrent to innovation within industries. Last but not least, any competitive disadvantage would be significantly reduced if all companies reported under a single requirement (Talha, Sallehuddin and Mohammad, 2007).

8. 0 Conclusion

In the nutshell, although narrative reporting seems to be unnecessary, it is up to the company on whether they want to report it or not. As mentioned earlier on in this report, if the company choose to have a narrative report, they might be a tedious task for the management team to prepare it but on the positive side is that by doing the report, it may encourage greater transparency. Since preparing a narrative report is not an easy task, the company pay want to conduct a proper planning before implementing it. For

example, the company may need to find a way to decide which area is inappropriate to be disclosed to the public and which is not. By doing this, the quality of the narrative reporting will be able to improve significantly overtime thus indirectly create more value towards the shareholders (Fraser, et al., 2010). Besides that, preparing a narrative report may also harm the company as in they might lose a competitive advantages towards they competitor. To avoid this from happening, the company might want to play safe and choose to disclose matters which related to critical success and trends as well as the metrics that the company use to manage their operation on a daily basis. In the other hand, if the company choose not to prepare a narrative reporting, they might face a problem in the future as their third party members might think that the company is not transparent enough in disclosing all their business transaction. Other than that, what if the accounting standard board chooses to make narrative reporting as a compulsory section in every company annual report in the future? (Beattie, McInnes and Fearnley, 2004)In the nutshell, even though narrative report seems to be able to provide a meaningful disclosure, it still up to the company whether they want to do it or not. If the benefit out weights the cost, there should not be any reason why every company not prefer to have it in their annual report every year (ACCA, 2011).