New Trends in Financial Reporting

Financial reporting is not a static discipline. It changes and evolves in response to new legislation, requirements of regulators and changes in accounting standards, as well as various other demands from other stakeholder groups and new initiatives. This article looks at some of the recent developments that are influencing financial reporting both internationally and locally.

More concise financial reporting

Recent years have seen financial reports of listed entities getting progressively longer and more complex, as more detailed accounting is required to keep up with and account for the increasingly convoluted structures and operations of these businesses.

Then there is the regulator impact. I am unaware of a case of a regulator being called to task for requesting more information to be disclosed. When directors, their external accountants or their auditors are called to account by regulators it is commonly about perceived insufficient disclosure. This impacts financial statement preparers and auditors by prompting them to err on the side of over-disclosure even if this is sometimes “boiler plate” type of information. At least by disclosing this they can then defend themselves to the regulators, and if necessary the Courts, by clearly showing that the accounting standards disclosure requirements have been met.

However the paradox of this trend of more detailed financial reporting is that the longer the reports get, the less they tend to be read and understood. I question how many shareholders ever read through the full annual report of a listed company, especially when that report can commonly be in excess of 100 pages in length. Even most accountants I know lose the will to live at a number less than that!

Hence there have been increasing calls for more concise financial reporting. Labelled by some as "cutting the clutter", this movement seeks to bring to life the statement "less is more". The main thrust is threefold:

1. Removing immaterial or insignificant disclosures in financial reports that may have built up over time.
2. Re-ordering and grouping notes and accounting polices so that all the information reported about an item or area is reported together in one place.
3. Re-writing wherever possible to simplify the language used. Plain English rather than painful English!

This all sounds easy and eminently sensible. However for anyone who has grappled with making the complex simple, this is not an easy challenge. Added to this is the fact that financial reporting still needs to comply with the relevant accounting standard and regulatory requirements. The good news though is that some leading companies are seriously grappling with this challenge and we expect to see more activity in cutting the clutter in the future.

Integrated Reporting

Increased profile of issues such as environmental impact, an appreciation of the wider concept of sustainability, as well as developments in information and technology have led to recognition that the success of organisations is not just about the traditional measures of financial and manufacturing capital. Instead companies are increasingly required to consider a range of other very important externalities such as environmental, social, intellectual etc.

This has led to an international movement grappling with how to provide a more holistic form of reporting for companies and even the establishment in 2010 of the International Integrated Reporting Council (IIRC).

The IIRC's CEO Paul Druckman stated "Integrated reporting is an attempt at getting businesses to tell their story (or strategy) by addressing six different capitals or stores of value they use to produce goods or services. These are financial, manufactured, intellectual, human, social and relationship, and natural capital. Information about financial and manufactured capital is currently provided by the financial report while information about natural and social capital is conveyed by a sustainability report. However information about intellectual and human capital is not yet well reported".

Hence an integrated report is an attempt to combine the currently disconnected financial and sustainability data, as well as the (as yet) mostly unreported information about intangible wealth.

If you are thinking that this sounds a bit esoteric, then you are probably not alone. While the initiative makes conceptual sense, the devil as always will be in the detail.

However some very serious international muscle is being applied to develop this integrated reporting concept both from international standard setters and corporations. Some of the world's largest businesses including Unilever, Coca-Cola, Microsoft, Hyundai, and HSBC are involved in piloting integrated reporting. As such we watch this space with interest to see what and how this may flow down to New Zealand businesses.

Performance Reporting for Charities

The new Public Benefit Entity (PBE) reporting standards issued by the External Reporting Board (XRB) and now imposed by law on registered charities contain a rather radical new requirement: Performance reporting by charities.

Rather than just requiring entities to provide an annual financial report with details of their income and expenditure and assets and liabilities, they are instead also required to provide information about the entity, why it exists, what it set out to achieve, and what it actually achieved.

This makes great sense. Unlike a profit seeking company, the success of a PBE is not easily, or indeed appropriately, measured solely by whether it made a surplus or a deficit. While a statement of financial performance is important hygiene information that can be a measure of activity and sometimes financial efficiency, it doesn't help assess whether a PBE organisation is actually delivering on its purpose. The reality is that other information such as service performance information is actually often far more important and relevant to stakeholders. Hence the changed requirement for PBEs to provide a more comprehensive performance report instead of just an annual financial report.

The performance report is designed for those users who cannot require the entity to disclose the information needed for accountability and decision making. Most users of a PBE's performance report will fall into two groups:

1. Providers of resources to the entity i.e. funders, donors etc.
2. Recipients of services from the entity

Critically these groups of information users often have very limited or no ability to be able to require financial information relevant to them for decision making. Also very relevant to "the why" is the fact that charities by virtue of their income tax exempt status granted by the Government are receiving a subsidy from the general public. As such there is a logical expectation that charities should be financially transparent and obliged to report in a way that provides meaningful information to the public.

While the performance report will still contain much of the accounting information that annual reports used to contain, it goes further in that it also requires some crucial entity information explaining what the entity is, and why it exists. It will also require performance information which will generally be a mix of qualitative and quantitative reporting.

The fundamental aim of this new style of reporting is to enable stakeholders to better assess an entity's performance and to improve the quality and consistency of reporting.

There is a saying that you get more of what you focus on. Performance reporting is designed to help focus the entity on reporting on its raison d'être, its reason for being. As anyone who has ever been to a meeting where financial reports are discussed and heard some minor amount like the telephone expenses queried will attest – giving people lots of financial detail is often counterproductive to focusing on the important matters. Rather than focusing on a lot of the detail the performance report essentially requires PBEs to report on their KPIs (key performance indicators). That is, those key measures that show whether the organisation is achieving its aims or not.

An organisation with a clear vision and mission that is then further expanded into a strategic plan with KPIs or other milestone targets should have little difficulty in providing a valuable performance report. And hopefully by forcing entities to consider their outputs and outcomes we should see better focus on the things that really matter towards achieving their purpose.

What are the challenges likely to be?

- → This is new and it is a change and that is always challenging until it becomes the norm.
- → There is no "one size fits all template". Organisations will need to think about what the key performance measures are that they should report. Good quality clear strategic plans will make this easier.
- → There may be the need for new reporting systems to be implemented to easily and accurately capture the performance information to be reported.
- → Presenting the information in a concise and easily understandable manner will be key.
- → Initially we expect much of the reporting to be output reporting but the quality will improve when organisations are able to able to accurately measure and report on outcomes.
- → Finally, for the very small percentage of charities that, to be frank, are not delivering good outputs/outcomes for the cost of running their organisations (i.e. "not providing bang for their buck" argument), this may be very challenging indeed and this new reporting may highlight these inadequacies and need for strategic changes in those organisations.

More detailed audit reports coming

The current audit report has been with us for some time now. It generally runs to over a page and sets out to clearly describe who it is being addressed to, what has been audited, the auditor's and the governing bodies' respective responsibilities, the basis of opinion and the audit opinion and date. This is a major improvement on the previous audit reports that were generally a brief paragraph of opinion only.

However since the Global Financial Crisis and especially the concern over the financial state of banks and other significant financial institutions such as insurance companies there have been loud calls for change to audit reports. In essence the calls have been for auditors to be far more descriptive and detailed as to what they have done, rather than just provide a largely binary pass/fail type of audit opinion.

At a simplistic level, this obviously sounds appealing. However most things in life aren't that simple and the development has various practical challenges which have caused some consternation amongst auditors and others. Specifically in regard to what and how much an auditor should disclose. Of some considerable concern to auditors is that their opinion should be on information disclosed by the client in their financial statements and not introducing new information. Another challenge for auditors is how to describe a significant risk or risks that have been the focus of attention during the audit and not to cause undue concern by doing so. There is the practical challenge of how to describe the risk, audit testing steps taken, and conclusion without undermining the overall audit conclusion. There is also the judgement of what level of detail to include and the balance between providing helpful information and not providing so much that it results in the audit report not being read at all.

So after much standard setting and wider stakeholder group debate regarding these and other issues there is now a new long form audit report coming with a requirement for auditors to include Key Audit Matters (KAM) in their reports. Auditors will be required to report on key areas of risk and outline in some detail the stress testing they undertook to satisfy themselves about the financial performance and position

of the company. The new audit reports also have some other changes such as re-ordering so the audit opinion is contained in the first section. Early trial examples of such reports run to between six to eight pages long.

Initially these new long form audit reports with KAM will just be mandatory in New Zealand for listed issuers and after a two year transition period to other FMC Reporting Entities with higher accountability. This essentially translates to listed entities and issuers in the old language. These will be effective for audits of financial statements for periods ending on or after 15 December 2016. There will also be a two year implementation period with a reassessment of this development to see if it should be extended to other entities after a further two years.

This increase in freeform disclosure within the audit report will not only lead to some interesting, and at times challenging discussions between auditors and management, especially as to what should/shouldn't be said. It will also come at a cost. The cost/benefit question will be another interesting aspect of this change.

Summary

The ongoing support of key stakeholders is critical to any organisation's success. Hence any improvement in communicating effectively and efficiently to those stakeholders is worth considering.

As such all organisations and those governing and leading them would do well to remain aware of reporting trends and consider how they may apply to their situation.

Auditors must also be prepared to play an important educational role, working closely with their clients, to ensure not only compliance, but also improved reporting.

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