Social and Environmental Narrative Reporting
Analysts' Perceptions

ACCA AND RESEARCH

Technological developments, globalisation, the knowledge economy... the environment in which we operate continues to evolve and with it the finance function. More than ever before, perhaps, there is a need to invest in accounting and business research to extend the evidence and knowledge base that underpins and helps develop the profession. ACCA is proud to be a leader in this development and has a firm commitment to initiating and funding research into some of the most important issues facing the accountancy profession globally.

As the largest and fastest-growing global accountancy body, with headquarters in London and an extensive network of nearly 80 offices and other centres around the world, ACCA is well placed to do this. This global perspective, together with a focus on current and practical matters, gives ACCA's research programme the edge to shape agendas and policy. Accordingly, ACCA's position is influential and its voice powerful: in the profession, in business and in the corridors of power. Results of ACCA's research are reported frequently in the professional and international press. Additionally, details of the ACCA research programme, together with published reports for download, are available at www.accaglobal.com/research

Contents

An ACCA research report, *Narrative Reporting: Analysts' Perceptions of its Value and Relevance* was published in November 2008. The research considered analysts' views on five key elements of narrative reporting, including social and environmental disclosures.

Due to the significant interests ACCA has in corporate transparency with regards to sustainability, this specific part of the research has been highlighted in this paper. The other parts of the research have been summarised only.

The full report has been published as ACCA research report no. 104, *Narrative Reporting: Analysts' Perceptions of its Value and Relevance,* by Dr David Campbell, senior lecturer in accounting, Newcastle University and Richard Slack, reader in accounting, Newcastle Business School, Northumbria University.

The report is available free of charge, in PDF from www.accaglobal.com/research
or as hard copy from connect.orders@accaglobal.com

Introduction

THE INFORMATION 'SUPPLY CHAIN'

The passage of information from reporters to consumers of corporate information is a complex one but an approximate 'supply chain' can be identified, at least as far as institutional stock market participants are concerned.

The reporting company makes disclosure through a number of media. These will typically include analysts' briefings at the time of the publication of the results, interim accounts, final annual report and accounts (usually several weeks after the initial analysts' briefings), 'stand alone' reports and press statements made to the press or through the investor relations department. Most of the financial information used by analysts is made available at the results publication date, some weeks ahead (usually) of the publication of the annual report. The annual report is mainly used, where it is used at all, for its narrative content and small items of financial information, not in the preliminary results (such as board members' salaries).

Based on their reading of a company's financial and other strategic information, sell-side analysts provide advice to buy-side clients. The formal channel for this is the analysts' report, produced to an approximate pro forma.

Publication is commonly through subscription-based online sources that are available to the buy-side, although informal contact also takes place where more robust views on individual stocks might be exchanged. The analyst's report, as a document in the public domain, tends to be carefully worded. In the event that 'coded' statements are not understood by favoured buy-side clients, the informal contact conveys enriching information over and above the formal report.

Sell-side analysts are a key part of the information 'supply chain', and the basis for the primary research undertaken for this report. The buy-side makes use of a number of sources of information but tends to rely quite heavily on sell-side analysts' reports.

The buy-side will typically receive several analysts' reports, through the online subscription provider, on any given sector or stock. The buy-side will typically look for 'snippets' of research 'over and above' the template or pro forma. Advice based on experiences beyond the financial information is valued, although because of the politics of the relationship between analyst and company this is often difficult to provide.

THE CHANGING ROLE AND CONTENT OF THE ANNUAL REPORT

Annual reports have grown in length over the recent decades. The general expansion of explanatory notes to the accounts, and the requirements under different corporate governance code provisions for more information, have been accompanied by some additional requirements under recent companies acts and listing rules. Annual reports have been noteworthy more recently because of the increased amount of narrative reporting. This is thought to be related to the increased public scrutiny of business activities and the assumed need to explain various aspects of activity not amenable to numerical conveyance.

Whereas, at one time, the annual report would be the only public document produced by companies, the changing landscape of corporate communications has reinforced the importance of questions on why the annual report is a suitable vehicle for some narrative disclosures. In addition to stand alone social and environmental reports, it is likely that the company website has become the vehicle of choice for most stakeholders seeking information on a company.

Methodology

RESEARCH QUESTIONS

Analysts were asked about five specific 'categories' of voluntary disclosure of narrative reporting, with the aim to identify the materiality and usefulness of such narrative disclosures to sell-side analysts. The 'categories' were:

- the importance of narrative reporting
- the chairman's statement and strategy reporting
- risk disclosures
- corporate governance disclosures
- social and environmental disclosures.

This short paper summarises the findings of the first four elements, but presents a fuller report on the findings of social and environmental disclosures. The full report can be viewed at www.accaglobal.com/research

In total, 19 sell-side banking analysts were interviewed from one sector. This single sectoral representation enabled intra-industry observations to be made. Second, it enabled the information needs of one particular cohort of sectoral analysts to be examined in detail.

The study focused attention on the analysts of UK banks for two reasons. First, it facilitated the interrogation of the perspectives and views of a high proportion of the London-based analysts of a strategically important sector for the UK and European economy. Second, there are ample reasons why all of the narrative disclosures under consideration in this research could be material and/or useful to investors.

METHOD

In order to identify a cohort of analysts to approach, the list of analysts that covered Alliance & Leicester plc was used as a starting point. The interviews took place at the London office of each analyst between the autumn of 2004 and the summer of 2006. The final number of suitable analysts interviewed for the project was 19.

At the start of each interview, the analyst was initially assured that his or her responses would be fully anonymised. After that, Alliance & Leicester plc's annual report and accounts for year-end 2003 was produced by the interviewer and the analyst was invited to describe how he or she would use the document if that was the first time they had seen it. This report was used for two reasons: first, it contained examples of all of the categories of narrative disclosure being studied; and second, it was more manageable in size in comparison to reports from some other banks.

The cohort of analysts interviewed for this research had an average of eight and a half years' experience in the job. The majority were not professionally qualified in accounting although all were qualified to degree level or higher. The most common academic backgrounds of interviewees were (in order) economics, maths, finance, accounting and law.

Evidence from analysts

OVERALL VIEWS ON THE ANNUAL REPORT

Almost all of the analysts interviewed discussed the limitations of the annual report in terms of the timing of its publication. While the year-end results are accompanied by the preliminary accounts, the final printed version of the annual report and accounts is often not published until some weeks later, by which time the information in the prelims has formed the basis of the analysts' forecasts. This publication lag significantly reduces the usefulness of the final document as an investment-material source of information. The detail in the preliminaries and the information conveyed by management at the results presentation are far more important in the intervening period.

Analyst A2 noted: 'On the basis that you get your report and accounts after you've already had the preliminary results, you are two months down the line from when you were actually given the specific… information in the preliminary results.'

The majority of the analysts referred to the document as potentially important for new information that is most likely to be in the detail and, possibly, in the notes to the accounts. In this regard, it is used as a historical document that contains more detail than the preliminaries. There was also criticism concerning the increased length and complexity of annual reports.

The contents of the annual report in general were considered by most to be potentially very relevant to the investment decision, although the cohort differed substantially in the use they made of the document.

One of the prominent emphases made by all of the analysts in the sample was the overwhelming importance placed upon the numerical financial data in annual reports. This was not an unexpected finding in that one of the main roles of an analyst is to forecast the key financial statistics over the forthcoming period and the recent history of those statistics is, therefore, of utmost interest.

The order of where the cohort referred to first in the annual report varied but, in almost all cases, the first 'port of call' was either the income statement or the notes to the accounts. The balance sheet was considered less important in most situations than the income statement and the cash flow statement was generally viewed as less material again.

A general scepticism with which reported figures were viewed was expressed by most of the cohort. Financial ratios given by the reporting company were never taken at 'face value', and other figures were frequently added back to reported costs and earnings, to arrive at what the analysts considered a more reliable figure.

THE IMPORTANCE OF NARRATIVE REPORTING

It was while discussing the annual report content outside the financials that differences of opinions between analysts became evident. This is the section of the annual report that has seen the most growth over recent years. In this context, 'front end' includes the collective disclosures that take narrative rather then numerical form. This section of the annual report would theoretically be of interest when the information sought is not available – or cannot be expressed by – the financial information. In practice, much of what is in the narrative sections is content already seen in the preliminaries, so it suffers from the same time lag limitation as other content of the annual report as a whole.

The cohort of analysts expressed mixed opinions on the materiality and usefulness of 'front end' narrative reporting. Despite misgivings, however, the consensus overall view was that the 'front end' was capable of containing content of material use to analysts, such as a statements about the management and monitoring of targets.

THE CHAIRMAN'S STATEMENT

There is no prescription in company law nor listing rules as to the content of the chairman's statement. In practice, chairmen have typically used the statement (or 'letter') as a vehicle for summarising the previous year's performance, to highlight any key changes, to acknowledge those who have contributed to any successes and to comment on 'going concern' and future prospect issues over the subsequent year.

There was a considerable and prevailing expression of scepticism over the value of the content. Analyst A13 provided a helpful summary of the way in which most analysts view the chairman's statement. 'I've yet to read one that tells us anything that we either weren't told at an analysts' meeting two months before the financials came out or that isn't part of a communicated strategy that's been around for ages.'

The most usual reason for the dismissal of the chairman's statement as a material and useful disclosure was its lack of detail and its cursory treatment of information on the company's strategy.

RISK DISCLOSURE

Risk disclosure and risk management information is one of the most notable additions to the voluntary content of annual reports in recent years.

The majority of analysts expressed scepticism about narrative risk reporting in the annual report. A typical opinion was that risk reporting was simply a 'boiler-plating' or a 'tick-box' exercise performed annually by companies without any real attempt to report on the actual changes in risk exposure over the year nor as anticipated in the year ahead. Most of the analysts relied on their own sector relevant knowledge of banking risks and risk management, and viewed disclosure as being, for the most part, meaningless to them. Moreover, the levels of disclosure were often regarded as being too simplistic for analysts on the one hand, but perhaps too complex for the individual non-specialist investor on the other. In this respect, it was suggested that risk reporting failed as a material disclosure for both types of annual report user.

Referring to the risk narrative, Analyst A5 said, 'that's generic what's written there and it's probably not even a very good description of [risk] to someone who didn't really understand [such as an independent investor]. Does it really tell you anything? No.'

There was, nevertheless, a general feeling that the presence of risk narrative was a potential source of comfort to analysts, even though the content was probably not of direct material interest. Only one analyst (Analyst A1) in the cohort of 19 expressed something approximating to a positive view of the current state of risk reporting.

CORPORATE GOVERNANCE DISCLOSURE

In the UK, corporate governance code compliance is voluntary in law but effectively mandatory under stock market listing rules. Companies can technically 'comply or explain', but in practice, large companies, and especially banks, normally comply in full to maximise market confidence. One of the results of the increased raft of corporate governance codes in recent years has been a substantial volumetric increase in corporate governance reporting.

With regard to reporting, the prevailing view was that while the presence of corporate governance content was important, it was of little materiality or use to the cohort of analysts. Others expressed blunter opinions, saying that they didn't read the corporate governance content at all.

"…absolutely useless
from my point of view."

"…don't give a damn.
Personally I might give a damn.
Professionally I don't care."

"…very laudable
but I'm not interested."

"…speaking purely from an
investment analyst perspective,
it's not useful at all…"

Social and environmental disclosure

There has been relatively little by way of interrogation of a user cohort as to the usefulness and materiality of social, environmental and ethical (SE) reporting. The evidence offered by the analysts in this study suggests a range of responses to this reporting category but with the prevailing belief that both social and environmental matters are of limited interest to the professional analyst and forecaster. In organising the evidence in this disclosure category, content is set out in five subsections, discussing:

- whether SE narrative is used and its materiality
- evidence that some analysts may misunderstand the nature of SE narrative
- environmental risk and disclosure
- the potential (rather then the current) materiality of SE reporting
- the way in which SE reporting is seen in the context of the whole annual report.

USE MADE, AND MATERIALITY OF, SE NARRATIVE REPORTING

Analyst A2 put the issue in some kind of context, saying, 'as I say banks, although they do have a part in the social fabric and so on…the whole kind of stakeholder idea – for what I'm trying to do [social and environmental reporting is] not that relevant really.' Analyst A15, as part of a commentary on his or her use of annual report contents said, 'corporate social responsibility report? Even more useless [than the chairman's statement and corporate governance].' Analyst A17 said, 'it sounds bad but from our point of view at the moment this CSR/environmental [disclosure] is close to useless.'

Upon probing in a little depth, it became apparent that social and environmental reporting was, for the cohort of analysts, perhaps the least read and least relevant part of the entire annual report. Analyst A1 was asked 'Are you interested in social and environmental disclosure at all?' which received the reply, 'Not really, no.' Analyst A2 said, 'Frankly I'd ignore it really' and Analyst A4 said that 'Corporate and social [disclosure was] definitely no use.' Analyst A7 reported that it was 'absolutely useless from my point of view.'

Analyst A1 confessed that, 'I've never really looked at one [a social and environmental report] before so I could be just alone [in my view, but] we've got so many pressures on our time that it's quite low in our list of priorities to actually read through that and if you've got to read the whole report that's going to be the last [thing you would read].'

Analyst A6 said that he or she would read the social and environmental report, 'very, very rarely…actually I don't think I've ever read through one.' Analyst A10 said of social and environmental reporting, 'don't give a damn. Personally I might give a damn. Professionally I don't care.' Analyst A11 said, 'very laudable but I'm not interested,' Analyst A13's view was that 'speaking purely from an investment analyst perspective it's not useful at all,' and Analyst A12 said 'I don't read that part of the account.'

Similarly, Analyst A16 said, 'I can't see any value in that section. I've probably never read one.' Analyst A4 had been dismissive about the rest of the business ethics reporting and was, similarly, dismissive with regard to environmental disclosure. 'Environmental blah blah blah. It's a bank,' implying that this identity this had a bearing on its interest in environmental matters. Analyst A13 said that environmental narrative was 'even less useful' than the social and ethical components. Analyst A14's view was, 'I think…it's a waste of money to be printing a lot of this and also I suppose there's a kind of irony in printing an environmental report that nobody reads.'

“I can’t see any value in that section.
I’ve probably never read one”

“These are more soft issues
and they wouldn’t be driving
the [forecasting] model.”

“I’m not convinced that, at the moment,
those sorts of considerations [such as]
CSR disclosures, drive share prices.”

With specific regard to social and environmental narrative and the question of materiality, the consensus view was that it was perhaps the least material (actual or potential) component of the annual report. There were, according to the cohort, a small number of situations in which it could be material to investment decisions but these were considered to be marginal: analysing for socially responsible funds or when a specific environmental risk applies. Analyst A6 reported that, 'if the client's funds aren't socially responsible… then this sort of stuff is obviously somewhat less relevant to an extent from that [materiality] point of view.'

Analyst A5 was asked: 'So in terms of your work as an analyst how you would judge the CSR component [of the annual report]?' Analyst A5 responded: 'Not material at all. There might be analysts out there who sit and read this from cover to cover but is there anything in here material that's going to affect the share price? No.'

Analyst A9 highlighted a limitation of all narrative reporting, to analysts, with specific reference to social and environmental content, saying that, 'These are more soft issues and they wouldn't be driving the [forecasting] model. We are about numbers. We are putting numbers in a spreadsheet and coming up with a forecast.' The implication of this comment is that unlike some other narratives, social and environmental reporting is unlikely to contain information capable of amending or informing any aspect of the financial forecasting model. In this respect, it seems there is a weak belief that any important environmental risks would be discussed in the social and environmental narrative.

Analyst A12 expanded on this belief. 'I know that there is an increasing demand in the market for ethical investment and those sorts of disclosures can help convince people of the ethics of investing in companies but we're really interested in financial performance and valuation. I'm not convinced that at the moment those sorts of considerations [such as] CSR disclosures drive share prices.'

Analyst A18 expressed a similar view. 'I wouldn't say they were completely useless but nothing from those sections go into our models on how the companies work. We never write about that section at all.'

MISUNDERSTANDING OF SE REPORTING

A small amount of evidence emerged that analysts may, in their unwillingness to (in some cases) read the social and environmental section of an annual report, have misunderstood its content. Analyst A4, for example, was dismissive, saying: 'Looking at it, its just sort of for customers who are deaf, hard of hearing or have speech impediments, a fully qualified sign language interpreter is available on request.' Analyst A14 was seemingly unaware of the more detailed content of social and environmental reporting that has been introduced in recent years. 'I don't think that corporate social responsibility has any bearing on socially responsible investor issues because its all about how much paper – well I'm guessing because I haven't read one – but I'm guessing its all about how much paper they've used and all this kind of stuff. Terribly irrelevant.'

ENVIRONMENTAL DISCLOSURE AND SECONDARY ENVIRONMENTAL RISK

One of the particular issues that the researchers wanted to explore with the cohort was the importance placed on banks' environmental exposure through its loan book rather than through its direct operations. Analyst A3 was asked about the general environmental risks for a bank. The interviewer added, 'You wouldn't see environmental risk as part of the risk of the business at all?' The answer was typical of those failing to recognise indirect environmental risk. 'Not really in a bank. Certainly if it was like a nuclear power station or an oil company I might worry about it a bit more'.

"…it may be nice to think about the environment a bit on the side but I don't like to inlay that decision into my pension pot."

Which section is the least material to you?

"it would probably be the environmental report."

"it wouldn't affect me if you lost the whole corporate responsibility section really."

Analyst A9 gave a blunt answer to the question of whether he or she would ever consider that banks might be complicit in pollution or expose themselves to environmental risks by their lending decisions, saying, ‘No. Straightforward answer. No.’

Analyst A17 expressed similar misgivings, saying: ‘If banks by their lending can be held accountable for what the company does with the loan that would make it close to impossible for banks to do anything. The environmental impact, just doing the actual report they would have to use half an entire rain forest just to publish the report’.

Analyst A18’s view was that it was not the bank’s purpose to moderate lending activity using environmental criteria. ‘I think, to be honest, that is the government’s job to regulate what industry does and I think ultimately the management of any company should try and maximise shareholder value.’

Analyst A13 was asked whether he or she could ever envisage a situation where the environmental exposure from the loan book would ever be material to an analyst’s forecasts. ‘From my perspective, and certainly given the tasks I have, I can’t imagine it ever being material.’

POTENTIAL MATERIALITY OF SE DISCLOSURE

Given the responses from the cohort on their views on the current relevance and materiality of social and environmental narratives, follow-up questions were asked on the situations that may increase their materiality in the future.

The size of the change needed was highlighted by Analyst A3 who was asked: ‘Could you ever see a situation where an environmental disclosure or a community disclosure would ever be material disclosure for you as an analyst?’

‘Yes I could. It would purely be if it was driven by my clients – if we end up with a huge socially responsible investment community that dominates the landscape. At the moment the sort of people like you and I invest in our pensions wanting to have a safe retirement, it may be nice to think about the environment a bit on the side but I don’t like to inlay that decision into my pension pot’.

Analyst A12 expressed two viewpoints. ‘Well the way things are going ethical investing is really taking off’ and continued by saying, ‘That’s a growing phenomenon so there are people in the market that are focusing on these things and if interest in those sorts of issues carries on growing at the rate that it has been then yes I can, in the future, conceive of a time when these sorts of things will be material.’

In concluding, however, Analyst A12 said, ‘but we’re actually a long way off from that now.’

LEAST MATERIAL PART OF AN ANNUAL REPORT

Given the general scepticism of the value of the SE narrative in banks’ annual reports, each analyst was invited to nominate a section that was the ‘least material’ to him or her in the conduct of their jobs as analysts.

Analyst A1 spoke for the majority, by saying, ‘for me as an analyst it would probably be the environmental report.’

With a note of sarcasm, Analyst A11 said, ‘I’ll shock you by saying the corporate social responsibility report.’ Some analysts discussed a situation in which the SE content was not present in the annual report at all.

Analyst A14 said, ‘No I wouldn’t miss it. It would greatly facilitate my reading of the rest of it because it wouldn’t be in the way,’ and continued to note that it was a section that, ‘nobody reads.’ Analyst A16 said that, ‘It will sound awful but it wouldn’t affect me if you lost the whole corporate responsibility section really.’

Discussion

ISSUES FOR PREPARERS

It is curious, given the substantial growth in narrative content over the years, that little systematic evidence exists for the actual manner in which corporate reporting information is consumed. While a part of the volumetric increase can be explained in terms in increased regulation and stock market listing requirements, it remains the case that the vast bulk of the increase is due to enhanced voluntary narrative. Reporters have bulked out their annual reports with more and more content, but little is known as to which audiences consume the respective parts of the annual report nor the actual or potential investment materialities of those components.

This study has found that at a fundamental level, the narrative contents of annual reports are relatively unimportant to analysts who are one of the most important primary consumers of corporate reporting information. There was no consensus among the cohort that any given narrative content category was actually, or even potentially, material and the majority view was that each section was less than useful. Some sections of narrative reporting were seen by the analysts as being of almost no actual or potential materiality at all.

The most common reasons given by analysts for the assumed immateriality of the relevant disclosures were the lack of numerical content, lack of granularity or the assumption that their own clients (the buy-side) weren't interested in information based on the type of voluntary narrative in question. So who is all this extra disclosure content actually for? Which audiences are conceived of when the content is being drafted? Some narrative sections were especially poorly thought of by the cohort of analysts. There were very few positive views on the chairman's statement while the risk narrative was considered largely 'boiler-plating' and the social and environmental content was universally considered irrelevant. A challenge appears to exist for reporters to take their readers' information needs into greater account when preparing for and drafting annual reports.

ISSUES FOR CHANGE AND ANALYSTS' INSIGHT

Evidence from this study suggests that analysts are very systems-driven and do not often think beyond the narrow confines of their roles in the capital market information 'supply chain'. It appears unlikely that they would be a source of pressure for change in terms of the social or environmental performance of businesses they cover as analysts.

They do, however, claim to be sensitive to the information needs of their own clients in the information supply chain. In this respect, it appears that pressure from the buy-side on such issues as environmental performance may cause a sell-side reappraisal of the materiality and value on social and, particularly, environmental reporting. It may be that investor pressure on the buy-side for, say, filtration by environmental risk, performance or reporting will present pressure for change in the environmental awareness of analysts. Internal change among the sell-side analysts themselves is unlikely though. The assumptions of capitalism pertaining to the supremacy of short-term growth and returns pervade the analysts' operational activity.

There may be some grounds for questioning the structural appropriateness of the analysts' skill set in interpreting narrative material for the purposes of financial planning and in respect of the failure to recognise the potential materiality of secondary environmental risk. The analysts were quick to dismiss narrative reporting as immaterial owing to its inability to be fed into a forecasting model, but a case could be made that, notwithstanding the perfunctory nature of much narrative reporting, it is the role of the analyst to interpret narrative content for the purposes of amending numerical forecasting.

The unwillingness to recognise the possibility of secondary environmental risk may be symptomatic of the short termism of analysts' financial forecasts.

TECH-TP-SEN

ACCA 29 Lincoln's Inn Fields London WC2A 3EE United Kingdom / tel: +44 (0)20 7059 5000 / www.accaglobal.com