



The UK Society of Investment Professionals

UKSIP is a member society of 

## Reporting Exposure Draft Reporting Standard 1 “Operating and Financial Review”

*A response to the*

***Accounting Standards Board***

*by the*

UK Society of Investment Professionals

### About UKSIP

The UK Society of Investment Professionals (“UKSIP”) is a professional organisation whose main aim is to foster and maintain high standards of professional ability and practice in investment analysis, portfolio management and related disciplines. UKSIP currently has some 5,000 members who work or have an interest in the UK financial services industry. Most members hold either the ASIP, CFA or recently introduced IMC designation. The ASIP designation is held primarily by those who successfully completed UKSIP’s former Associate examination, which was similar to the CFA. UKSIP is the UK-based member society of the CFA Institute, the organisation that develops and administers the Chartered Financial Analyst (CFA<sup>®</sup>) Program.

UKSIP also develops and administers the Investment Management Certificate (IMC), the benchmark qualification for those working in investment management in the UK. Over 15,000 investment professionals have passed the IMC.

### About this response

#### **Background**

As UKSIP’s members are major users of financial statements, the Society has long supported the use of the Operating and Financial Review (OFR). UKSIP believes that the OFR should set out the strategic framework that the directors have established for the entity and be a means of providing both quantitative and qualitative information about the enterprise. The Society endorses the International Accounting Standards Board’s (IASB’s) contention that the OFR should assist users in the *“evaluation of the ability of the enterprise to generate cash and cash equivalents and of the timing and certainty of their generation..... Users are better able to evaluate this ability to generate cash and*

*cash equivalents if they are provided with information that focuses on the financial position, performance and changes in financial position of an enterprise.”* (IASB Framework Paragraph 15). With this in mind, UKSIP has consistently encouraged the companies to make as full and imaginative use of the OFR as possible. The Society has been disappointed that past initiatives by the Accounting Standards Board (ASB) and others have not been more enthusiastically adopted by the corporate sector. In framing its response, therefore, the Society has considered the factors that may lie behind this historic reluctance by companies to embrace past initiatives and which may also serve to inhibit the wholehearted adoption of the current proposals.

First, UKSIP recognises that most managers are committed to their businesses, endeavouring to deliver acceptable, sustainable, long term returns for shareholders. UKSIP believes that a frank and open dialogue with shareholders is always the best approach. However, occasions arise when management mistakenly thinks that by limiting the flow of information to shareholders, it can present itself and the business in a more favourable light. As a consequence, the information provided in such circumstances can be unbalanced and insufficient for most shareholders and investment professionals acting on their behalf. Another possible factor that may encourage management to portray as favourable a short term picture of the business as possible, is the increasing use of share price performance criteria as the basis for incentivising executive reward. UKSIP's firm opinion is that, over time, the market rewards those managements displaying a consistent frankness about their company. Candour - despite what some managers may believe - is beneficial and instils confidence amongst investors.

The second major reason for the lack of a complete information results from short comings within the capital markets themselves. Shareholders, and more particularly their agents, the fund managers, rarely demand, in a coherent, effective and focused way, improvements in the financial information provided when it is felt to be inadequate. Many fund managers have neither the time nor the resources to commit to such activities and are not directly rewarded for it.

Whilst the Draft Standard does not address these issues directly, UKSIP understands the thinking behind the approach being adopted and supports the ASB's current proposals.

### **Overview to Draft Standard**

UKSIP supports placing the reporting needs of shareholder users of the published financial statements at the heart of the document. Whilst the needs of the capital markets are important – and others will find the information valuable - UKSIP believes that it is crucial that the OFR is written primarily to inform existing shareholders of the entity, as their needs are paramount and the directors should be acting in their best interests. Allowing the focus of the OFR to broaden and include prospective shareholders and other outside parties would inevitably damage and unnecessarily dilute the contribution to financial reporting that the OFR can make.

UKSIP also believes that it is entirely correct that the OFR is written through the eyes of the directors themselves. It is important that shareholders can see the business as perceived by its board of directors. In this way, and irrespective of whether shareholders agree with that perspective, they should have a better understanding of how the directors intend to run the business.

As responsible owners of the business, some shareholders have their own internal checklist of those issues on which they expect management to report. That checklist may not be the same as that of the directors but it is important that investors can make the comparison independently. UKSIP does not favour mandating a particular checklist, as

any formal template could inevitably result in boilerplate reporting of the worst kind. The Society, therefore, fully supports the ASB's decision not to mandate a set format for reporting, it also supports the proposed disclosure framework, which provides a set of guidelines within which directors have the opportunity to offer investors a comprehensive insight into the business.

Inevitably the danger with such a flexible approach is that it can afford the opportunity for bland and/or unbalanced reporting with a lack of clarity. UKSIP therefore encourages the ASB to establish with the Financial Reporting Review Panel (FRRP) clear benchmarks of performance, which will enable the FRRP to take a proactive line on inadequate OFRs, especially when shareholders bring them to the Review Panel's attention. The Society hopes that the FRRP will be adequately resourced for this task. Equally, the Society recognises that it will also be important for users of accounts to increase the pressure on companies to produce high quality reporting under the Standard.

It is crucial, in UKSIP's, view that companies provide Key Performance Indicators (KPIs) and a range of other supporting measures to illustrate both the dynamics of their performance and the drivers of economic value against the strategies that they have set for the business and themselves. There is concern that companies will be reluctant to disclose sufficient KPIs and useful quantification or commentary on future targets. On behalf of users of accounts, UKSIP would suggest a company would not be able to report performance against strategy meaningfully to their shareholders without providing a minimum of three KPIs as defined. UKSIP remains reluctant, however, to recommend this formally because of its preference that companies be allowed the opportunity, to demonstrate their approach to reporting to shareholders. The Society would suggest, however, that the FRRP rapidly develops a set of benchmarks for acceptable practice in delivering an adequate OFR and would suggest that, unless there are valid reasons, the expectation would be for a minimum of 3 KPIs. Additionally, auditors should be instructed - when deciding whether the OFR is consistent with the accounts - to ensure that summary high level data which is presented to the Board regularly is automatically considered for disclosure in the OFR as a KPI or Other Measure.

## Response to questions

*Q1 Do you agree with the proposed principles for the preparation of an OFR contained in paragraphs 5 to 24 of the draft text? Do you think that there are any other principles that should be included?*

UKSIP agrees with the principles as proposed but suggests that the term "investors" be replaced by either the term "members" or "existing shareholders" as they alone should be the central focus for the OFR. Potential shareholders will undoubtedly find the OFR of use but neither they, nor any other outside party, should be a focus for the OFR.

Paragraph 12 should perhaps be rephrased, requiring discussion of any predictive comment which significantly fails to be borne out by subsequent events, whether adverse or beneficial.

*Q2 Do you agree with the proposed approach whereby the Reporting Standard provides a disclosure framework rather than any more detailed list of requirements for the preparation of an OFR?*

Agreed as explained in the comments above.

*Q3 Do you think that there are any other elements to the framework that should be added in order to encourage focused and relevant reporting in the OFR?*

UKSIP would encourage the early establishment of performance benchmarks in order to prevent bland and inadequate reporting.

*Q4 What are your views on the Board's proposal to extend the list of particular matters in paragraph 27 beyond those specifically referred to in the Regulations?*

UKSIP wholeheartedly supports the Board's approach - it follows a logical sequence and puts the requirements under the Regulations in a much better perspective of overall reporting to shareholders.

*Q5 Do you agree with the proposal that the Reporting Standard should not specify any particular Key Performance Indicators (KPIs) that entities should disclose in the OFR, nor the number of KPIs that should be included?*

Agreed, as explained in the comments above.

*Q6 Do you agree with the proposed disclosure requirements for KPIs set out in paragraphs 73 to 74? Do you think that they will encourage entities to report on KPIs or result in less disclosure?*

UKSIP agrees with the proposed disclosure requirements but, as outlined above, it suspects that corporates will be reluctant to disclose many KPIs. The Society therefore urges the ASB to take other steps to encourage acceptable levels of disclosure.

*Q7 Do you agree with the proposal that the Reporting Standard should encourage "other measures and evidence", both quantitative and qualitative, in addition to LPIs, to support the information provided in the OFR?*

UKSIP fully supports this proposal as it provides an additional insight into the entity

*Q8 Do you agree with the proposal that where qualified measures, other than LPIs, are included the disclosure requirements should be less onerous than those for KPIs?*

Agreed.

*Q9 Do you agree with the proposal that illustrative examples of KPIs should be given in Implementation Guidance that accompanies, but is not part of, the Reporting Standard*

Agreed.

*Q10 What are your views on the Implementation Guidance? Are there any further examples that might usefully be provided?*

UKSIP supports this approach. It would however recommend that the ASB should require a full reconciliation to be provided for any KPI or significant Other Measure based upon the financial statements. The Society is aware of instances in the past where, for example, ROIC calculations were based on the financial statements but only in a highly manipulated form that could not be replicated by an external reader of the accounts.

**February 2005**