The KPMG survey of business reporting

Better Business Reporting

kpmg.com/betterbusinessreporting

Welcome

Is it time to re-focus business reporting?

Restoring Trust: Why we need better reporting

Many management teams are frustrated at the perceived short term focus of investors. On the other hand, it is also true that many investment managers are frustrated by the perception that management is too focused on driving value in the short term and are aware that company management can exchange long term business prospects for short term earnings performance.

A key reason for this situation is that the focus of communication between managers and owners is principaly on historical earnings performance. The extent of shareholder value creation is rarely visible in an annual report. As a result, investors have limited objective information with which to assess whether the longer term, value creating prospects of the business have been truly enhanced. The historical financial statements will tell you whether revenues are growing but they won't necessarily tell you whether the customer base is getting stronger.

Said another way, the financials may tell you how *much* money the company made, but not necessarily how the company *makes* money. And more importantly, whether the current year earnings provide a long term sustainable proposition for value creation. Against this background, it is time to ask whether the historical focus of today's annual reports is driving short term decision making, resulting in a bias against investment in longer term prospects.

In many parts of the world, investor presentations have developed as a means of providing a broader picture of performance. They can be more timely as they are not tied to the annual reporting cycle, but they still have a tendency to prioritise short term earnings over long term value. Businesses investing in the long term have an interest in moving their investor dialogue beyond this narrow picture. Good narrative reporting providing quantitative and qualitative information should give investors more confidence in the reliability and completeness of the picture presented in other more timely communications.

Delivering a more relevant report

There have been a number of reporting initiatives in the wake of the global financial crisis aimed at finessing existing areas of financial reporting. There is no doubt that the quality of financial information is essential for effective investor decision making but we believe that a broader debate is required. It's time to step back from the detail and ask whether the current balance and focus of reporting is right for capital markets' needs.

Mark Vaessen tested the premise that fundamental reforms to reporting are needed by interviewing ten international leaders in the field in *"The future of corporate reporting: towards a common vision (2013)."* All agreed on the need for change, but they did not concur on how far-reaching the reforms had to be or what should be altered. This survey has been undertaken to provide a basis from which to support this debate, to invite comparison over where reporting stands now, against what it needs to deliver in order to support the efficient functioning of the capital markets.

> "...it is time to ask whether the historical focus of today's annual reports is driving short term decision making."

About this survey

This survey has looked at the reports of some 90 companies across ten countries over a five year period. The definition of an 'Annual Report' varies across regulatory environments. The survey looks at the primary reporting document used in each country (for example, the '10-K' in the USA) and refer to this as the 'annual report' throughout.

We have looked at corporate responsibility information to the extent included in annual reports, on the basis that this should address those issues that the organisation considers to be material to shareholders and investors. Many companies also provide additional information, aimed at a broad range of stakeholders in a separate report. You can read more about this in the *"KPMG Survey of Corporate Responsibility Reporting, 2013."*

Supporting change

I hope you find this survey thought-provoking. You can find more ideas on how annual reports can be developed to provide a broader perspective on shareholder value creation at www.kpmg.com/betterbusinessreporting.

Larry Bradley
Global Head of Audit
KPMG International

56% of audit committees name customer focus as a top three value driver.

7% of companies provided performance data on customer focus or satisfaction.

85% of reports did not identify brand & reputation as a key risk.

4 the average number of **operating performance** measures in an annual report.

41% of audit committees name R&D as a top three value driver.

15% of companies provided objective measures of IP creation / capability.

21% of companies did not provide any operating measures of performance.

22% of manufacturing and engineering companies provided product related performance measures

80% of UK companies reported an adjusted GAAP measure.

1 PAGE reduction in report size since **Integrated Reporting** was adopted in South Africa (compared to an average increase of 25 pages elsewhere).

3% Annual increase in report size over five years.

The future of reporting?

A broader perspective on business performance could help to restore trust between business and investors

Re-thinking the role of the annual report

Ask a member of the public – or indeed many investment professionals – why companies should prepare an annual report and they'll tell you about the importance of having a reliable earnings number as a basis for assessing business value and how it has been managed. Ask an accountant, and you'll get a different answer. They're more likely to focus on the essential role that the annual report plays in helping shareholders assess management's stewardship of business assets by summarising the results of huge volumes of transactions.

Society needs business reporting to address both these perspectives. This means acknowledging the role that business reports play in investors' buy/sell/hold decision making - alongside the essential role they play in shareholder assessments of stewardship. To achieve this we need to look beyond refinements to our established financial reporting frameworks. Historical financial information provides a solid foundation from which to build an assessment of value but we need a broader perspective to help investors take their assessments beyond current year earnings.

I believe that we need to broaden the debate on the future of business reporting to encompass areas beyond the financial statements. We need to ask ourselves how well the reporting package as a whole aligns with the information needs of investors. At the moment we have lots of information on the capacity of the business to generate earnings tomorrow but much less to support a view on how this might change in the medium term or how the long term prospects of the business might be affected by potentially game-changing issues.

Management teams are telling KPMG member firms that they are frustrated by apparent investor short-termism. I believe that better business reporting could provide investors with the objective information they need to take a longer view.

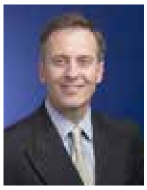
> "...we need a broader perspective to help investors take their assessments beyond current year earnings."

> "additive changes to the annual report are unlikely to bring about the degree of change required"

Where next?

One of the underlying messages from this survey is that additive changes to the annual report are unlikely to bring about the degree of change required. It may be tempting to look at recent corporate failures and layer in a set of disclosures that would have given warning – but the danger is an ever-expanding report that addresses someone else's corporate challenges rather than the business's own.

An alternative is to place the onus on the organisation to tell its story through its eyes, using compliance disclosures as a foundation rather than an end point. Readers may like to take a look at the IIRC's Integrated Reporting Framework which takes this approach. There are many different public perceptions of Integrated Reporting but its focus on communicating business value creation to providers of financial capital should align closely with a shareholder-value focused annual report. KPMG has been a long-time supporter of Integrated Reporting as a potential solution to this challenge.



David Matthews
Board member and Head of Quality & Risk Management
KPMG in the UK

A broader perspective on value creation

The gap between reporting content and business value needs closing

Are we asking too much of financial reporting? It plays an essential role in explaining past performance but on its own it cannot provide a complete picture of business value. More is needed to help readers understand how management is driving the business forward and how changes in the business environment might present new opportunities and challenges.

This gap is increasingly being filled by investor presentations where a more forward looking perspective on business value is provided.

There is danger with this approach, though. The quality and content of these presentations varies, and they may address only some aspects of business value. Boards may also be concerned with the communication of some of their most price-sensitive messages being driven through less formal reporting channels without the backstop of the annual report.

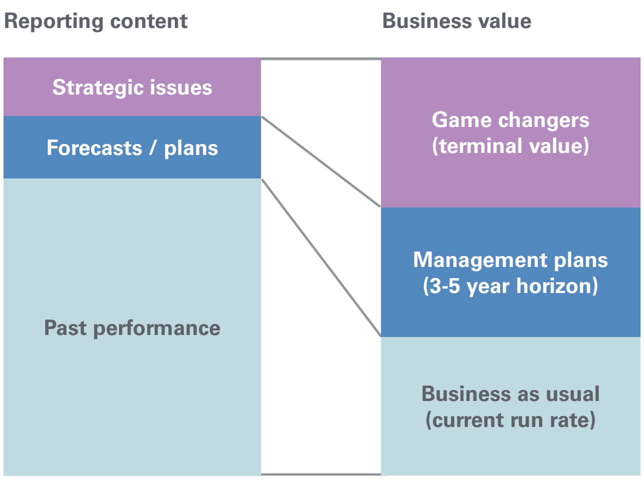
A better approach lies in the narrative reporting content of the annual report. It is time for this to evolve to provide a picture of how business value is being developed and protected. We need to see reports built around a company's unique business model, addressing the unique factors that drive long term value for that business.

In practice this means:

- more focus on the operational drivers of performance;
- more focus on the resources on which the business depends; and
- providing readers with the information to form their own views on future performance.

Many companies are saying they are frustrated by investor short-termism. This is an opportunity for them to help the capital markets take a longer term view of their business prospects by providing the information to support that view.

The Reporting Gap



Closing the gap

Cash flow models of business value typically have three components of value – 'business as usual', the value added from management's plans and expected changes in the business environment, and assumptions about the ability of the business to generate returns over the very long term.

The focus of traditional business reporting on past performance creates a gap between the information reported and the information needed to assess business value. The danger is that this reporting gap creates uncertainty which must be priced as a risk premium into the organisation's cost of capital.

Key findings

Four suggestions to help reports support better investor decision making

The case for a new approach

Over the last five years we have experienced a period of unprecedented business shocks that have led some to question the relevance of the annual report. At the same time, reports have become bigger (by around 15%), despite the emergence of 'cutting clutter' as an established part of the reporting agenda. Against this background, report preparers will be naturally wary of any incremental proposals to change reporting.

Marrying these two challenges will require a change of reporting approach. Therefore, rather than looking at tweaks to reporting obligations, the aim of our survey was to look at the overall direction required for reporting improvement. With this in mind, we highlight four broad areas for reporting development.

1. Align performance measures with the drivers of shareholder value

Earlier this year, KPMG's Audit Committee Institute asked audit committee members from around the world to identify what they considered to be the top three key performance drivers for their business. Comparing these responses to our survey findings, it is striking how few companies report performance measures over the most commonly identified drivers of business value. The most frequently cited value driver by audit committee members (operating efficiency) was addressed at an operational level by only 21% of the companies in our survey. The second most common driver, customer focus, was addressed by 7%.

There are patches of good performance reporting – notably, the reporting of IP development in the pharmaceuticals industry; operating efficiency and capacity in the natural resources sector; and customer base in the telecoms sector. These examples show that good practice can evolve but the challenge is for other sectors to adopt a similar attitude, and for businesses in all sectors to work towards providing a more complete picture of performance.

It may be tempting to approach this challenge by imposing a system of metrics to measure the business against. But, the more relevant challenge lies in finding the right question to answer. For example, a number of reports now provide information on staff retention, but few answer the question: 'is the business retaining its most important staff?'.

How these questions are answered will depend upon the unique circumstances of each business and industry. We have provided some high level guidance later in this survey but ultimately we believe that boards have an essential role to play in ensuring that the content of their reports address what they consider to be the most important drivers of their business.

> "it is striking how few companies report performance measures over the most commonly identified drivers of business value"

	Identified as a top three value driver[1]	Companies providing a related operating KPI
Operational efficiency	66%	21%
Customer focus	56%	7%
Supply chain	42%	8%
Brand & reputation	42%	2%

Note[1]: KPMG's Audit Committee Institute: 2014 Global Audit Committee Survey "a missed opportunity to provide a more complete perspective of performance"

2. Recognise that the financials are only the start of the story

Financial statements make up a little under half of the average annual report. They have an important role to play in explaining how the business has been operated and they provide a base-line from which to assess the ability of the business to generate future earnings. Many report preparers seem to regard this as being the end of the story, though – despite the broader perspective intended for narrative reporting. One in five businesses provide no operating measures of performance other than corporate social responsibility and employee data that is typically required by statute.

Regulators in different countries have specified a variety of objectives for narrative reporting, mostly linked to a shareholder value theme. In reality, though many narrative reports are predominantly focused on explaining the financials rather than the underlying operating performance and capability of the business. Accounting measures comprise half of all key performance indicators reported.

The average report provides four measures of operating performance. We see this as a missed opportunity to provide a more complete perspective of performance and shareholder value creation. Non financial operating measures can provide leading indicators of business prospects and communicate progress in managing key business drivers that financial indicators cannot. For example, customer acquisition rates and product quality measures can provide insight into the ability of a business to grow or maintain its revenue base.

The result is that, at present, the weight of reported information does not reflect the drivers of business value, and therefore could align better with investor perspectives of value.

3. Join up reporting content – Don't leave unanswered questions

Responsibility for preparing an annual report is often delegated across a range of departments within the organisation. Unless these contributors start with a common vision, and work to bring their individual reporting strands together into a coherent whole, reports can become a series of disconnected issues, leaving the reader unable to assess the implications of the matters raised.

Nowhere is this better illustrated than with risk reporting. Throughout our survey, we found that risks were being identified but the level of supporting analysis was generally limited to high level mitigating actions that might apply to any business in the sector or beyond. The result is that these disclosures provide little information of value to the reader. We did occasionally see supporting analysis in relation to exposure to commodity price fluctuations, with a small number of businesses providing sensitivity analysis showing how changes in commodity prices might have affected historical earnings. However, this is rare. Whilst the type of supporting analysis will vary according to the risk, we encourage businesses to adopt a similar approach to their other significant risks.

Some reports are now demonstrating a clearer link to the business model or business strategy. We believe this is the right basis from which to build a clear explanation of business value creation. One of the benefits of Integrated Reporting in South Africa is that this approach is much more apparent there – though many are still finding the link to performance reporting a challenge.

"reports can become a series of disconnected issues, leaving the reader unable to assess the implications of the matters raised."

4. Refocus reporting culture

One of the biggest barriers to change is the pervasive culture in reporting of focusing on compliance rules without looking at the bigger picture. Two related changes could help to address this:

1. Take a business-focused view

Reporting rules can provide a starting point for explaining the business story. For some they also define the end point – the reader is left with the strong sense that the disclosure has been given to meet an obligation rather than to inform. Such reports can struggle to explain reported measures in the context of real-world business performance, and they frequently focus on the past business rather than the future. The lack of direction is sometimes also carried through into investor presentations.

For this reason, we believe the alternative of building the narrative reporting around the business model provides a stronger foundation for the report than a compliance framework can. At present, however, many business model descriptions lack the detail to provide this foundation, and address only some aspects of the business. A business model based approach should be more natural for report preparers but it will require a 'big-picture' perspective to be introduced into report preparation processes that have traditionally been sub-divided into specialist areas. To support this, business strategy leaders would need to play a more prominent role in contributing to the direction and content of the report.

2. Understand the audience

If the issues that the report needs to address should be defined by the business model, the information needed to explain their implications should be defined by the audience. Reports prepared without an understanding of the reader's needs may address the right issues but are unlikely to provide information that is relevant to the reader's decision making. For example, many business strategies are centred on developing a particular aspect of the customer base but performance measures are rarely segmented in this way, even though that is what a reader would need as a foundation for assessing the potential earnings impact of the strategy.

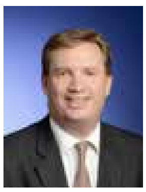
This has been apparent in the early attempts to implement Integrated Reporting in South Africa where some reports have attempted to meet a wide range of stakeholders' needs. Arguably, the level of investor interest has been less than it might have been because early reports have lacked the performance information needed for the reader to make an assessment of risk or future earnings implications. More widely, this can be seen with intellectual capital reporting – reporting standards focus on the question of capitalising past expenditure, whilst the bigger question of whether the business has the capability to sustain its IP position goes unanswered in many reports.

Achieving better reports

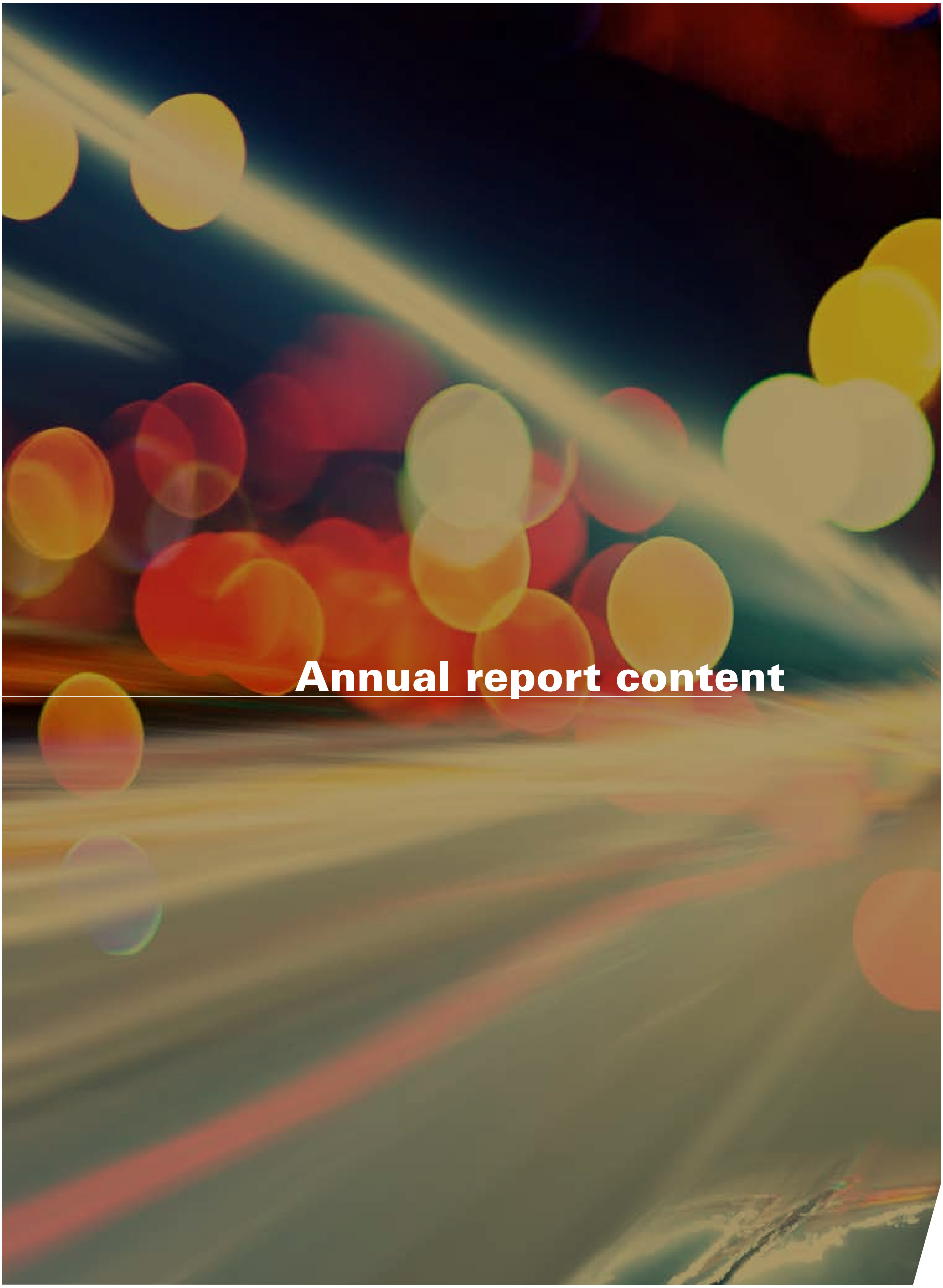
> "businesses that are investing in their long term future should have a strong incentive to make this investment more visible"

We have outlined four broad areas for reporting improvement. Is regulation required to achieve this? Regulators may be able to 'push' reporting in the right direction, and act as a catalyst for change, but the central message from our findings is that reports need to become more business-centric: this is not something that we believe can be prescribed by a detailed compliance based checklist. Self interest may therefore be a more significant driver of change. Businesses that are investing in their long term future should have a strong incentive to make this investment more visible so that their strategy can be distinguished from those prioritising short term earnings.

> "the central message from our findings is that reports need to become more business-centric"



Matt Chapman
Better Business Reporting
KPMG in the UK



Annual report content

Annual report content

Building a better annual report

There is no globally accepted definition of an annual report as a single package. For this survey, we have taken it to be the organisation's primary reporting document, combining compliance based information on the financial statements, corporate governance, and remuneration, with a narrative commentary. Despite the varied practice, reports increased in size in every country except one – South Africa – on average 22 pages over five years.

Additive disclosures (such as the extensions to remuneration reporting in many countries) can have a role to play in developing reporting but the danger is that reports become ever expanding. Two further challenges emerged from the survey:

- Many reports feel more like a series of independently drafted disclosures than a coherent picture of the organisation's business story. Outside of South Africa, it is rare to see matters raised in one section of the report, being picked up in another. The result is that strategies and risks are disclosed but performance in managing them is not.
- The financial statements are an important part of the report but they cannot provide the whole story. Narrative reporting provides an opportunity to look beyond this with both qualitative and quantitative disclosures but instead much narrative reporting is built around compliance disclosures made elsewhere in the report, rather than explaining how the prospects and value of the business has been enhanced.

Addressing these challenges will require report preparers to step back from the traditional rules-based approach to reporting to focus on matters that are most relevant to the business model and strategy, and to provide the information on those matters that are most relevant to the intended reader of the report – generally shareholders and investors.

Good business model and strategy descriptions could provide the foundation for a better report

Detailed Report Content

Disclosures on performance, risks, and governance address the key features, opportunities, and challenges identified in the descriptions of business model and strategy.

Business Model

- All the essential aspects of the business model are covered - from supply chain and inputs, through business processes, to outputs and customers
- Sufficient detail is provided to give context to matters that are raised elsewhere in the report
- The business model addresses the external context in which the business operates as well as internal processes

Strategy

- The strategy for developing the business model addresses both the medium and long term future of the business
- Strategy descriptions focus on business operations rather than broad objectives such as shareholder returns or business values
- The external forces expected to shape the operating environment are addressed in addition to internally originated change

Reporting focus

The average report now contains 165 pages of commentary and data but does it address the big picture?

What we mean by an 'annual report'

The term annual report means different things in different countries. This survey has been based on each company's primary reporting document, as a minimum covering:

- Narrative reporting – covering quantitative and qualitative commentary on the business model, strategy, risks, and opportunities, and business performance / outlook;
- Governance reporting including directors' remuneration reports;
- The full financial statements – where abridged financial statements were presented, we have instead taken account of the separately published full financial statements;
- Any other information included in the primary reporting document

In the USA we have looked at 10-K filings, excluding share plans and other one-off attachments but also taking account of separately presented annual report sections where explicitly referenced in the 10-K. We have also taken account of governance and remuneration disclosures which are presented in separate (but referenced) proxy statements in Canada and the USA.

For convenience, we refer to this information collectively as the 'annual report' throughout this survey

Our survey has not included separately prepared corporate responsibility reports which are typically prepared for a broad range of stakeholders. We think it is reasonable for readers to assume that matters material to the business will already be addressed in the annual report.

The complications involved in defining an annual report illustrate one of the frustrations investors face when analysing a portfolio of companies – it is increasingly difficult to establish whether a report represents the full-suite of information. Whilst KPMG member firms are generally supportive of efforts to reduce and simplify reports by separating out less relevant information, it is with the caveat that it should be immediately apparent what other documents the reader needs to look at to see the whole picture – without needing to search through the text of each report.

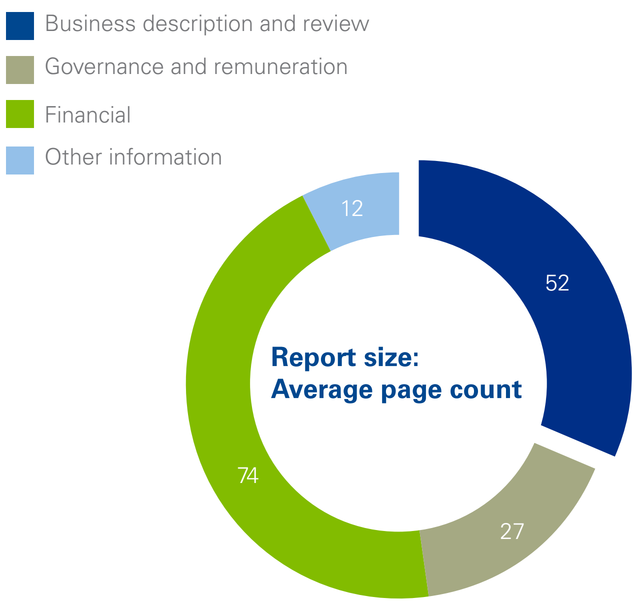
Reporting focus

The average report in our survey was 165 pages long, with just under half of this devoted to the financial statements.

It will come as no surprise that the focus of reports is heavily weighted towards historical financial information. But, not only are annual reports dominated by the financial statements, much of the narrative discussion is also rooted in the financial results. This is, of course, a reflection of how business reporting has developed.

The result is that the balance of reporting is out of line with the balance of business value – the focus of reported information emphasises a 'business as usual' view of the company. This perspective is important but it does not tell the full story. If investors are being asked to take a longer term view, businesses will need to provide them with relevant and reliable information to support this.

> "The focus of reported information emphasises a 'business as usual' view of the company"



Source: The KPMG survey of business reporting, 2014

Management commentary

The management commentary provides an opportunity to look beyond the financials to a broarder range of business value drivers – but is it being taken?

Different approaches to management commentary

Whilst most countries in our survey follow IFRS for financial reporting, there is no equivalent global standard for management commentary, with regulators in the ten countries surveyed approaching management commentary requirements from a variety of different perspectives.

The result is a range of reporting frameworks, focusing on different audiences (investor, shareholder, and stakeholder) and aimed at different objectives (business value, value stewardship, and asset stewardship). This is often supplemented through legislation for additional public policy driven disclosure requirements.

In practice we saw limited focus on the needs of any particular group of readers, with reports generally focusing on describing what the business had done in a financial context rather than, what the reader might need to know to assess shareholder value creation and business prospects.

This is particularly true for risk reporting – the right risks may be identified, but there is often little to help the reader understand how those risks have been managed or what they mean for future prospects.

Reporting culture

A key reason that reports are failing to connect with investors' needs appears to be down to reporting culture. Report preparation is dominated by the compliance based approach of financial reporting – it can be difficult to step back from this. Even in the relatively free-form management commentary sections, it is apparent that many report preparers see a compliance obligation rather than an opportunity to communicate their value creation story to the reader.

We believe that audit committees can play a vital role by stepping back from the detailed reporting process to challenge whether reports meet readers' needs as well as compliance obligations.

> "…. many report preparers see a compliance obligation rather than an opportunity to communicate their value creation story"

Country	Primary Focus	Purpose
Australia	Shareholders	Assessment of financial performance, position, strategies and prospects
Canada	Investors	To help an investor decide whether to invest or continue to invest
Denmark	Users[1]	To support users' economic decisions
France	Investors	To comment on the financial performance of the company
Japan	Investors	Reports are prepared on a voluntary basis; no guidance applies
Norway	–	An overview of the development and results of operations and the entity's position
South Africa	Investors (originally stakeholders[2])	To explain to providers of financial capital how an organisation creates value over time
Sweden	–	A description of activities and a review of business activities and financial position and performance
UK	Shareholders	To explain the main trends and factors underlying the development, performance and position of the entity
USA	Public capital providers	Matters that would cause the reported financial information to be not indicative of future operating results or financial condition

Note [1]: The Danish Fnancial Statements Act requires the annual report to be prepared for users whose economic decisions would normally be affected by the report.

Note[2]: Companies in South Africa preparing an integrated report in accordance with the King III governance code initially followed guidance in the IRC of South Africa's 2011 discussion paper on Integrated Reporting which emphasised a stakeholder audience for the report. Since then, the IIRC's International Integrated Reporting Framework has been published. This emphasises an investor focus for reports.

Does size matter?

Reports continue to get bigger

Typical report size

Most reports in our survey were 50-200 pages long – though the figure would be significantly higher if our survey had covered the financial sector. On average the large[1] companies' reports were 57 pages longer than the smaller (US$1 billion) companies. Larger companies devoted an additional 27 pages to the business description and review and 19 pages to the financial statements.

We do not believe that there is an ideal size for an annual report – they should be as big as they need to be, and no bigger. Report preparers need to be alert to the fact that the reporting process has a tendency to drive clutter, with the same matters covered in several sections of the document from the perspective of different business functions, and with less important matters carried over from previous years. However, the most important consideration is not the size of the report but the risk that important information is missed by the reader.

Elsewhere in this survey, we have noted a number of areas where we believe there are reporting gaps, notably in the reporting of risk and operating performance. We found little correlation between the amount of information provided by companies in these areas, and the overall size of their reports – the reports with the most information in these areas were generally in the 100-200 page range.

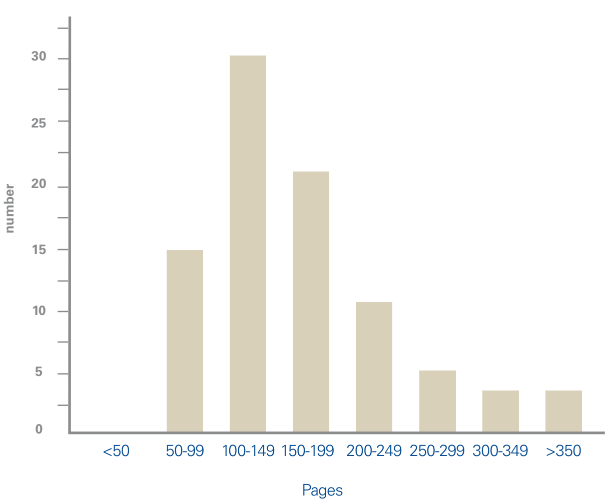
Still growing

We compared reports with the equivalent report from five years previously. The difference – 22 pages represents an average annual increase of 3%. One of the largest change relates to business description and review. Bigger companies in particular are devoting more space to this aspect of the report. Whilst this has added to the volume of reports, it is also a step towards re-balancing the weight of reporting, enabling a more forward looking perspective than can be provided by the financials alone.

There has been a growing focus on corporate governance and executive pay driving additional disclosures in a number of countries. In other areas, the size of the financial statements has increased, though by less than we had expected – the impact of additional IFRS requirements appears to have been offset by the cutting clutter agenda.

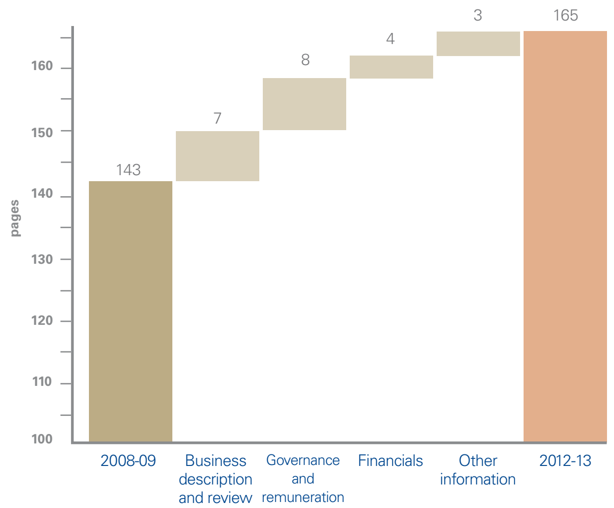
> "the most important consideration is not the size of the report but the risk that important information is missed by the reader"

Size of reports – Number of companies producing reports of a certain size



Source: The KPMG survey of business reporting, 2014

Change in report size over five years



Source: The KPMG survey of business reporting, 2014

Note[1] Refer to 'Methodology' for a description of the survey population.

National practices

Countries can learn from their different approaches to reporting

Reporting in France

Every aspect of French reports was significantly longer than our average. As a result, all but one of the French company reports in our survey were over 200 pages long, with half being over 300 pages. In addition to being the largest reports in our sample, French reports were also growing at the fastest rate – some 5% per year.

A key reason for the difference is that listed companies in France file an annual registration document (used as the basis for our survey) based on disclosure obligations in the EU prospectus directive. This is done irrespective of whether the company intends to raise capital. Whilst other countries' annual reports cover similar areas, we believe that the approach in France is a key factor in driving greater report volume.

Does the additional reporting volume provide more valuable information? Later in our survey, we look at the range of operating performance measures that companies are providing. French companies provide more of these measures than our average – but significantly less than in the UK where reports are typically half the size.

A second difference arises from Grenelle II and other statutory disclosure requirements. Whilst many companies include selected ESG data in their annual reports, French companies include the Grenelle disclosures in their registration document irrespective of their materiality to shareholders.

In addition to the regulatory differences, we also believe that reporting culture is playing a significant factor in the overall length of French reports. Report preparers can sometimes place a higher priority on compliance with detailed disclosure obligations, irrespective of materiality to the business or the intent behind the requirement.

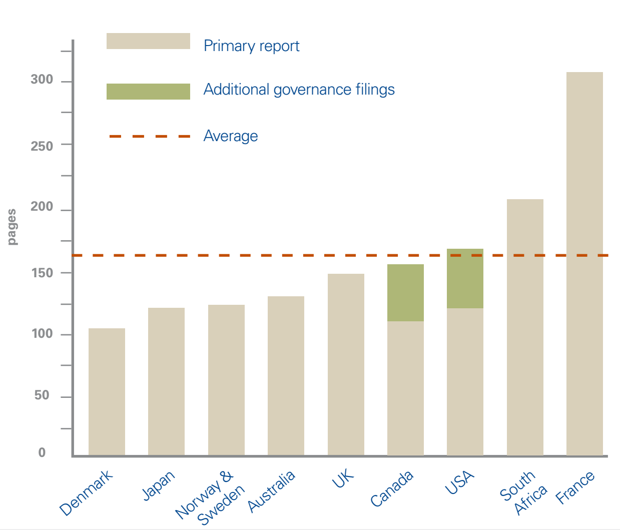
Comment – Frustration with reporting bulk

Many companies in France have expressed frustration with the apparent ever-increasing volume of financial and non-financial information they are required to disclose as a result of European and French national regulatory expansion. The volume of superfluous and overlapping information has drawn particular attention. It is also leaving investors confused as they struggle to find the relevant data to incorporate into their decision making.

Several companies are now taking a step back to think about reducing clutter, simplifying their reporting and making sure it is really relevant to investors. In France, we are seeing that the Integrated Reporting initiative is helping to catalyse this thinking.

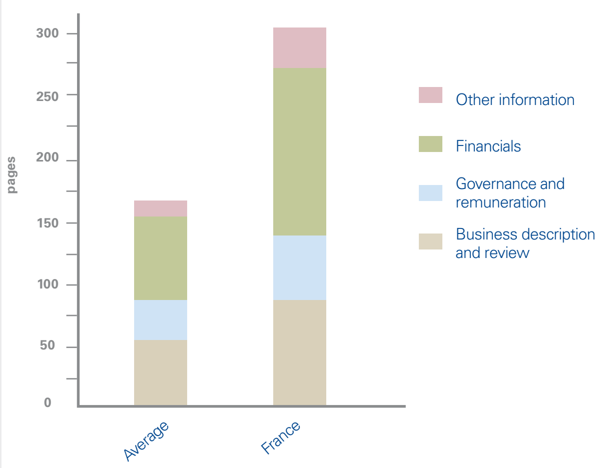
Jean-Florent Rerolle
Corporate Finance
KPMG in France

Average report length



Source: The KPMG survey of business reporting, 2014

Reporting in France



Source: The KPMG survey of business reporting, 2014

Reporting in Japan

Whilst Japanese companies are required to make securities filings including financial and corporate governance information, there is no obligation to prepare the equivalent of an annual report. In practice, many do prepare one on a voluntary basis, though we believe many smaller companies see them primarily as a means to provide summaries of their full statutory filings to retail investors. We have included the full financial statements in our survey where this is the case (which includes parent company as well as group financial information). It is notable that prescribed disclosure formats sometimes mean that similar space is devoted to parent company financials as for the group – whereas in many countries the parent company information occupies relatively few pages.

Given free rein to determine their annual report content, the larger Japanese companies devoted more space to their narrative reporting, notwithstanding the shorter overall length of their reports. This was also the part of the report that these companies had expanded the most – some 30% over our review period.

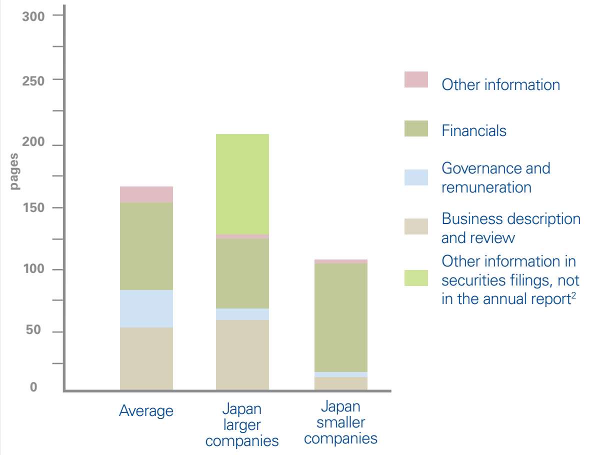
Japanese companies (along with those in France) are also unusual in providing twelve month forecast data (including revenue and operating income) as a voluntary disclosure recommended by the stock exchange.

Regulatory activity in the US

One relatively recent development noted in the US is that the SEC has started to challenge companies on inconsistencies and gaps in their reports by comparing them to other sources of company information such as analyst presentations and calls.

This trend is perhaps an illustration of the importance of boards being satisfied with the overall focus and messaging of their reports, as well as the detailed reporting process behind them.

Reporting in Japan



Note[1] Includes separately filed financial statements where these are not provided in the annual report.

Note[2] This information which includes parent company financial statements is not included in our survey

Source: The KPMG survey of business reporting, 2014

Comment – Differing reporting practices in Japan

There are marked differences in reporting practice in Japan, with the largest companies increasingly seeing their annual reports as an opportunity to support a broader, international investor base. Meanwhile, the smaller companies – all of whom had market capitalisations in excess of US$ 1billion – were often focused on producing summaries of their security filings. The contrast leads us to the question of whether reporting practice risks impeding investment in these companies.

Yoshiko Shibasaka
Better Business Reporting
KPMG in Japan

Financial reporting

Variations in the length of financial statements produced under the same reporting standards

Relevance of the financial statements

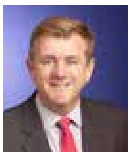
Financial statements continue to be an essential element of annual reports. They provide an objective and comparable building block from which to understand a company's performance, its current ability to generate earnings, and a basis for assessing the stewardship of the business. Whilst they cannot provide the whole picture of business prospects, they will remain at the core of investor assessments.

For a while now preparers have been voicing their concerns over disclosure overload – e.g. presenting 'at-a-minimum' disclosures, regardless of their materiality. They have asked for ways to de-clutter financial statement disclosures and provide more company-specific information, telling a relevant story that is unique to their business. Many users agree.

Standards setters (both IASB and FASB) have factored these concerns into their disclosure initiatives, which aim to improve presentation and disclosure in financial reporting.

Comment – Improving financial statement clarity

The IASB's Exposure Draft on proposed amendments to the presentation of financial statement is a welcome first step, even if only a small one, in a bigger disclosure initiative through which the IASB aims to improve presentation and disclosure in financial reporting. However, the real ask here is for behavioural change from preparers, auditors and regulators alike.



Mark Vaessen
Global IFRS Leader
KPMG International Standards Group

Differing financial reporting behaviours

All of the countries in our survey except the USA and Japan have adopted IFRS, so one might expect a degree of consistency in the average length of financial statements. In practice, though, whilst most companies take 50-60 pages to present their financial statements, those in Australia, South Africa, and France are taking significantly more. There was relatively little variation across industries, though it is worth emphasising that our survey excluded financial sector organisations. These variations point to significant differences in reporting behaviour under IFRS. We see three underlying reasons for this:

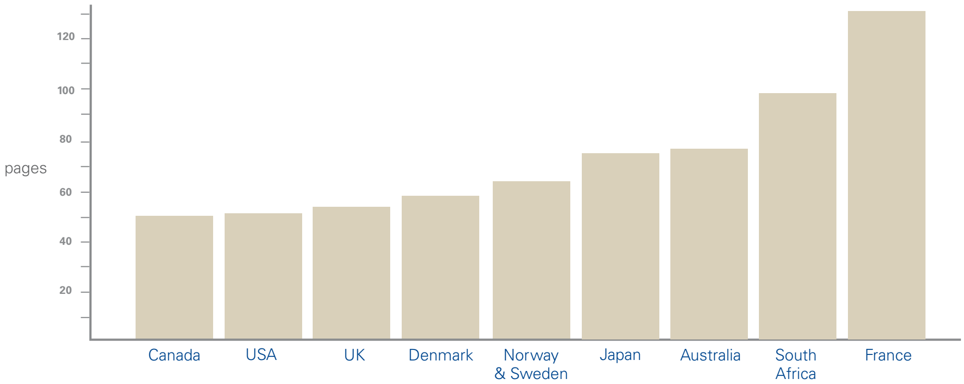
1. Local regulatory environment – Some regulators and legislators provide specific guidance regarding format of presentation for financial statements and additional detail required. Regulatory attitudes can also inadvertently promote defensive compliance by encouraging immaterial disclosures to prevent regulatory challenge.

2. GAAP heritage – Despite transitioning to IFRS, companies may present items in a way that is similar to previous GAAP. For example, GAAP heritage may be apparent in the line items presented, or the level of disaggregation.

3. Interest in the 'cutting clutter' agenda – In some countries, most notably with the FRC in the UK, there has been a regulator-led drive to improve the clarity of reports by encouraging companies to eliminate immaterial information. This has helped to offset some of the additional disclosure requirements introduced into GAAP.

Additionally, whilst most countries include parent-company financial information, this is not universal. In general, this adds relatively little to report length but here again there are significant national differences, with parent company financial information contributing an average of twenty pages in France.

Average length of financial statements



Source: The KPMG survey of business reporting, 2014

The role of the business model

A good business model description can provide a foundation for shifting the report from a compliance document to a business-centric one

What we found

We saw a range of different interpretations over what constitutes a 'business model'. Some focused more on business strategy, emphasising change initiatives; others emphasised underlying business values, such as customer focus, environmental awareness. There is a place for both these discussions but we do not believe they provide readers with the understanding of the business model that they need.

Our survey suggests that report preparers should be focusing on three challenges in particular:

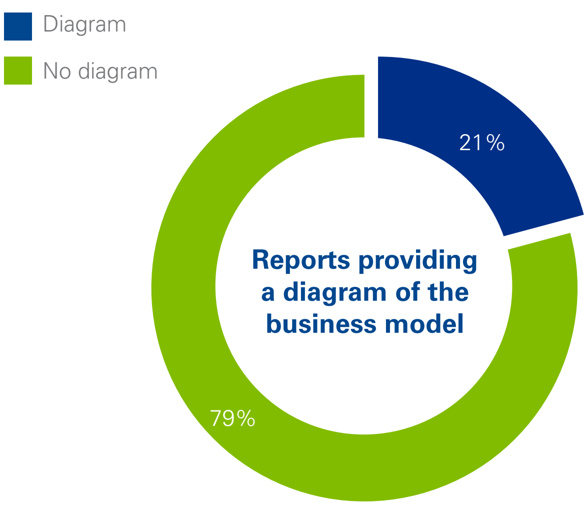
1. Does the description of the business model align with management's view of the significant business value drivers? In short, is this how management want their future earnings prospects to be assessed?

2. Are all the aspects of the business model that are expected to have a significant impact on prospects in the short, medium, and long term addressed? – Many descriptions only address those aspects of the business that are relevant to the immediate strategy, rather than longer term aspects of value

3. Is enough detail provided to give effective context? For example if the business contracts in a different way with a key set of customers, are the implications of this apparent?

Use of diagrams

Whilst still not common, diagrams are becoming increasingly popular as a basis for explaining the business model. They can provide an accessible basis for explaining the business model but are sometimes included as a substitute for detail. Some of the descriptions we saw were at such a high level it was difficult to identify the industry they related to. Descriptions of this nature provide little useful information and simply add to reporting clutter. However, others formed a valuable basis for understanding the key business processes and the range of interactions it has with the outside world.



Source: The KPMG survey of business reporting, 2014

The basis for a business-focused perspective

Opinions on the value of describing the business model in the report differ. Some believe it adds unnecessarily to the volume of the report – after all, won't most readers already have a good understanding of the business model?

We believe it is important for two reasons:

- Firstly, it is the starting point for building a business-focused picture of the business – in contrast to the compliance approach that prevails in many reports. This is important because many reports do not address all the significant features of the business model – we believe this is a key reason why the provision of operating performance measures is so patchy. The discipline of describing and then linking to the business model should provide a basis for a more completed and better connected narrative.

- Secondly, the business model provides an essential source of context. Reports cannot anticipate every issue that might affect the business but a good business model description will provide a basis from which readers can begin to assess the potential impact of events as they arise.

"Some of the descriptions we saw were at such a high level it was difficult to identify the industry they related to"

Risk reporting

Risk Reporting

Better risk reporting

Risk reporting provides an opportunity to explain how the company is managing the potential impact of major risks on shareholder value. Given the amount of effort most companies put in to managing their key risks, it is surprising that few are providing explanations of risk management progress beyond the compliance requirements.

Some common observations from our survey were:

- Risks identified that are of limited relevance to shareholder value – sometimes driven by established national practices or regulatory requirements.
- Few risks identified in relation to the achievement of growth or the implementation of growth enhancing strategies – though these may be amongst the most significant drivers of shareholder value.
- Limited use of supporting explanations to help the reader assess the potential impact of the risk and how it is being managed. Where they are provided, explanations of mitigating actions are often at too high a level to be helpful, giving the impression that they have been written in isolation from the operations of the business.

We encourage businesses to see their risk reporting as an opportunity to explain how they have protected shareholder value rather than merely a list of things that could go wrong.

Three steps to better risk reporting

1 Focus

- Risks highlighted are the most relevant for an understanding of business prospects.
- Risks of not achieving business opportunities are covered, as well as risks of loss.
- Key risks are readily distinguished from less relevant compliance disclosures.

'I can readily identify the most relevant risks to shareholder value.'

2 Context

- The part of the business potentially affected by the risk is identifiable.
- Information provided helps readers to form their own views on the potential impact of the risk after mitigating actions.

'I can assess the potential impact on the business if the risk crystallises.'

3 Linkage

- Governance disclosures show how the Board manages the risk and explains the level of risk it chooses to accept.
- Progress indicators demonstrate the steps taken to manage the risk.
- Risk indicators demonstrate the extent to which risk drivers have been reduced.

'I can see how the risk is being managed and the progress in controlling it.'

Overview of risk reporting

Too many risks, not enough detail?

Risk of what?

We saw a number of different approaches for determining risk disclosures. Some companies focused on risk to the balance sheet, others identified factors that might affect short term earnings, whilst a minority addressed non-business factors that might cause share price fluctuations.

Most reports surveyed focused on risk to 'business as usual' rather than risk to the future business. As a result, they may be missing some of the most significant risks affecting business value drivers.

We believe a more useful benchmark is whether a risk would be relevant to an assessment of the intrinsic value of the business – i.e. its ability to generate earnings over the long term. Looked at through this lens, short term fluctuations in market rates take on much less significance, whilst 'game changing' risks potentially affecting the shape of the business model become more significant.

Prioritising disclosure

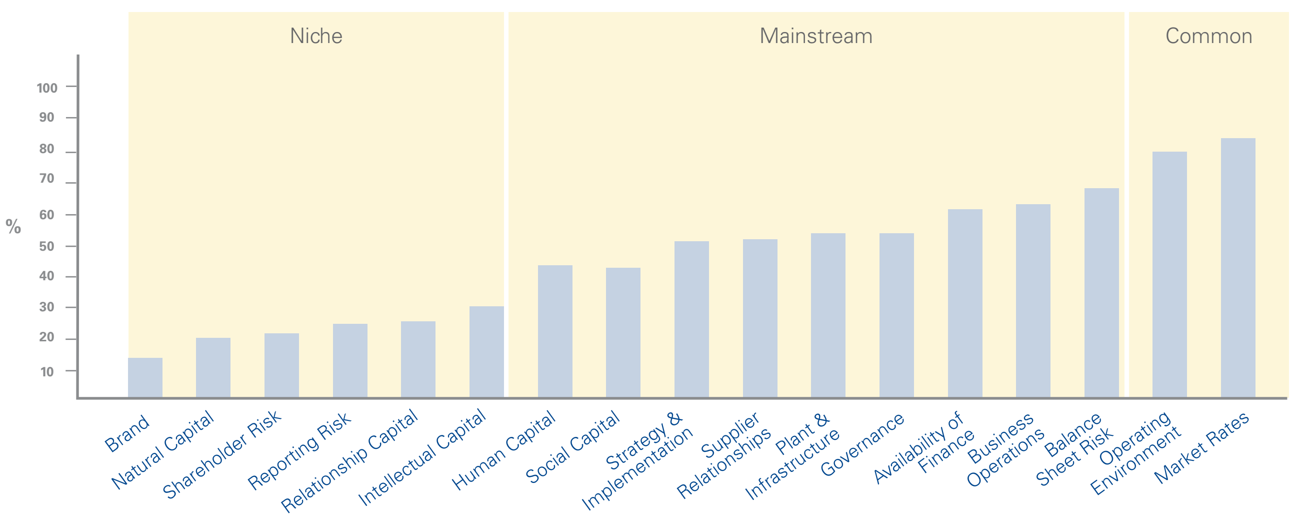
There is no right number of risks but report preparers should recognise that there is a limit to the number of factors that even a sophisticated investor can incorporate into an assessment of shareholder value creation, and ask themselves whether the risk is something they would themselves take into account in assessing future business prospects.

We were hoping to find balanced disclosure of the most significant risks. Investors have repeatedly expressed frustration at the amount of clutter they need to wade through – therefore we believe it is important that companies should not simply 'disclose everything' and leave it down to investors to identify the most significant issues.

Some risk categories may be symptomatic of reporting clutter. Reporting estimates, shareholder risks (such as share price volatility) and balance sheet risk may be relevant to the future prospects of the business but we suspect that they do not always reflect the business's key operational risks.

> "Most reports focused on risk to 'business as usual' rather than risk to the future business."

Proportion of companies surveyed raising at least one risk in each category



Source: The KPMG survey of business reporting, 2014

We also found certain categories of risk disclosures had become standard practice in some countries.

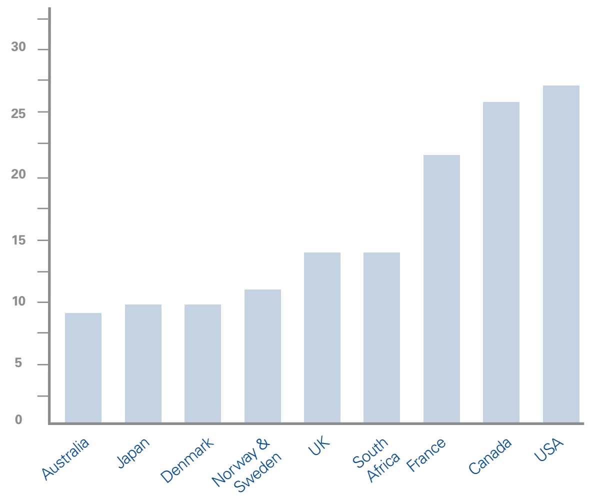
'Standard practice' risk disclosures

Risk	Countries(*)
Market rates	Australia; Canada; Denmark; France; Norway / Sweden
Finance / liquidity	Australia; Canada; Norway / Sweden
Customer credit	Australia; Norway / Sweden
Macro-economic	Canada; USA
Staff retention	Canada
Business continuity	UK
Continuity of supply	USA
Data security	USA
Political and regulatory uncertainty	USA

Note(*): Countries where two thirds of companies reported the same risk

Of course, in some instances these disclosures will address a specific business-critical risk. But in others, we suspect they are simply a generic risk of doing business. Do these types of disclosure help the reader? Perhaps, if the disclosure contains information to enable the reader to assess the specifics of the risk – for example, if an exchange rate risk disclosure is accompanied by earnings sensitivity analysis – but this level of analysis is rare.

Average number of risks raised in each country



Source: The KPMG survey of business reporting, 2014

Connecting with the reader

If a risk is identified as significant, readers will naturally want to gauge the potential impact but whilst mitigating actions are sometimes disclosed, the description is generally brief and progress in managing the risk is rarely reported. The result is that many risk disclosures do not enhance the reader's understanding of business prospects.

The concept of reporting linkage (ie connecting matters raised in one section of the report with analysis in other sections) is particularly relevant to risk reporting. Applied to risks this would mean:

- Explaining in the governance section of the report how the board approaches and oversees each of the key risks;
- Explaining the strategy for managing these risks, including the appetite for risk;
- Providing indicators of risk appetite and performance in managing the key risks in the discussion of operating performance and prospects;

As well as improving the focus of risk disclosures this approach could make governance disclosures less generic, and descriptions of long term strategy more relevant to shareholder value.

> "many risk disclosures do not enhance the reader's understanding of business prospects"

What's not being reported

There are some surprising gaps in organisations' assessments of key risks

Risks we expected to feature more prominently

Strategy & implementation – almost half the companies surveyed did not identify any risks in relation to strategy & implementation

This broad category of risk (covering strategy selection, execution, and change management) was raised by 53% of businesses, though often specifically in respect of post-acquisition integration. Many of the companies surveyed had nevertheless outlined ambitious strategies for developing the business. We suspect there is a reluctance to talk about this type of risk because it addresses the risk of not achieving an opportunity, rather than of losing an existing asset. This is unfortunate as a large element of business value may be dependent on its ability to overcome the risks in delivering its strategy.

Brand – only 15% identify risk to brand & reputation

It was particularly surprising that less than half of the retailers in our survey had identified brand as a key risk – this is likely to be a key, and potentially fragile, asset for any consumer focused organisation.

A larger number identified risks associated with social capital which may have an impact on brand but we were surprised that more didn't take a broader perspective on brand importance.

Intellectual capital – outside of pharmaceuticals, only 21% of reports identified intellectual capital risks

Intellectual capital was widely recognised as a key risk by pharmaceutical companies but this was not the case in other sectors. Intellectual capital can take many forms other than product patents – but few reports seemed to recognise this. Businesses in the engineering sector, for example, may depend on proprietary processes or solution design skills. We encourage a broader perspective when identifying the risks to intellectual capital.

Competitor challenge – 19% identified competitor threat and 16% identified business relevance as a key risk

Few companies outside France and the USA identified competitor activity or entry from a new market participant as a key risk, perhaps reflecting an assumption that the market status quo would be maintained.

Risk free – 3% of companies felt they had no significant risks to report

These companies were in Japan (though companies that file a short annual report do still include risks in their securities filings) and Denmark

Reporting on opportunities

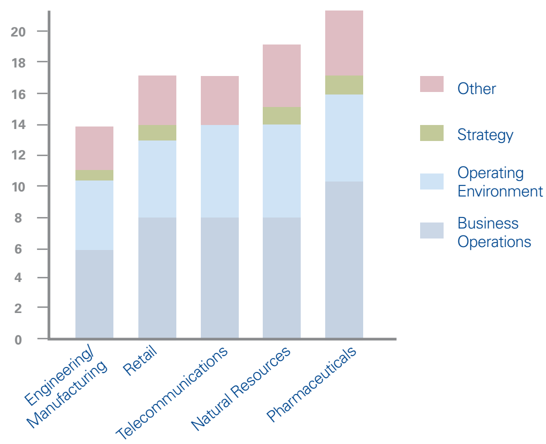
For many companies, a substantial part of business value lies in their strategy for developing the business. The risks to this strategy are likely to be amongst the most relevant in a consideration of shareholder value, yet they have very little prominence in most risk discussions.

We suspect that there are a number of cultural reasons why these risks receive little reporting focus. Firstly, those responsible for preparing detailed disclosures are often reluctant to discuss future opportunities, even the risks of not achieving them. Secondly, many report preparers see the world through a balance sheet lens, focusing on risks that might result in a balance sheet loss, rather than an earnings fluctuation.

Industry specific risks

The average report raises thirteen risks. In addition to the four risks identified in the panel, we had expected that a number of other risks would feature more prominently in certain sectors' top thirteen risks. In particular: Supply chain continuity / dependency was identified as a risk by under a third of retail businesses; product quality and operating performance were respectively identified by only 25% and 31% of engineering business; and adverse societal impact was identified as a risk by only 13% of natural resource companies.

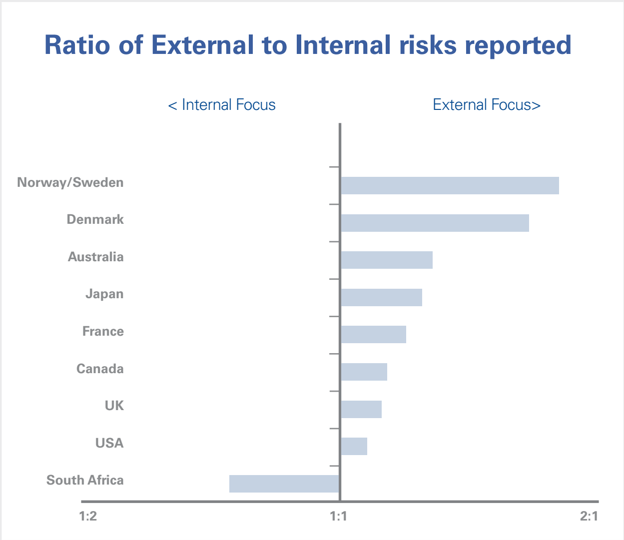
Risk profiles by sector



Source: The KPMG survey of business reporting, 2014

National practices

Different perspectives on risk



Source: The KPMG survey of business reporting, 2014

An external perspective

Our survey looked at the mix of risks being reported, categorising them into internal risks – i.e. those that management has direct control over – and external risks which are most likely to be triggered by an external event. Some of the most common external risks drive sales relationships; regulatory approvals & change; and economic & market conditions.

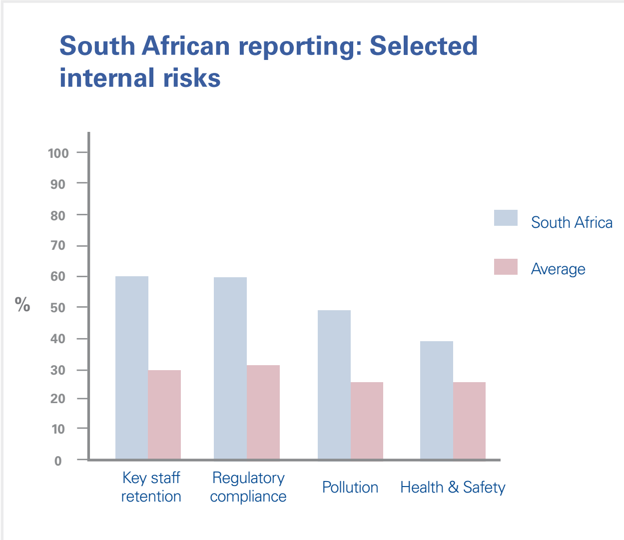
Most reports included a mix of both types of risk – both are relevant to an understanding of business prospects. However, it was also clear that there were variations in national practices when it comes to identifying particular categories of risk. Whilst we weren't looking for a particular ratio in the reporting of external and internal risks, we consider it is understandable that the weight of risks identified relate to external factors. Outside of strategy execution risk, for most companies external factors are likely to represent the greatest risk to shareholder value over the long term.

Practice in South Africa

Whilst South African companies identified a similar number of external risks, they also identified more internally facing risks than others – in particular relating to:

- Staff retention;
- Health & Safety;
- Pollution; and
- Compliance with law & regulations

One possible reason for this is that many South African businesses adopt an Enterprise Risk Management model, typically focusing on more immediately controllable 'operational risks' rather than those derived from the external environment.



Source: The KPMG survey of business reporting, 2014

Performance Reporting

Performance Reporting

Better performance reporting

Narrative reporting provides an opportunity for organisations to focus on those measures of performance that are most relevant to their longer term prospects and value. We encourage businesses to take a hard look at the relevance of the measures they are currently reporting.

Our survey highlighted a number of challenges for businesses looking to align their report content more closely with their operational priorities:

- Many KPIs do not address the key drivers of business value, drawing instead on the compliance disclosures in the back of the annual report. The result is a predominance of ratios taken from the financial statements or mandated ESG disclosures, and fewer measures associated with the development of key business assets (such as the customer base) and operational efficiency.
- Where operating KPIs were provided, it was often over one or two aspects of the organisation's business model, leaving the reader to question how the other aspects were being managed.
- Matters raised elsewhere in the report – such as the implementation of key business strategies or risk management activity are often not followed up with performance information that could demonstrate the level of progress being made in managing the matter.
- Measures are often provided at a level that does not align with investors' decision making processes. For example, information on staff retention may be provided on a business-wide basis when the business critical factor relates to retention of technical expertise.

Three steps to better performance reporting

1

Address the key value drivers

- Performance measures address the most significant drivers of value in the business model, including the extent to which critical business resources have been developed and protected.

'I can see KPIs for the most significant aspects of shareholder value'.

2

Provide measures relevant to business prospects

- Leading indicators of performance are provided as well as, or in place of lagging measures of financial outcomes.
- Measures address progress in managing risk and implementing strategy together with operational outcomes.

'I can see leading indicators of performance that help me form my own views over future prospects'.

3

Align measures with investor decision making

- KPIs address the specific part(s) of the business where the issue / opportunity lies (rather than business wide).
- Sufficient context is provided to enable the potential impact on different parts of the business to be assessed.

'I can incorporate the measures provided into my assessment of business value and prospects'.

Explaining performance

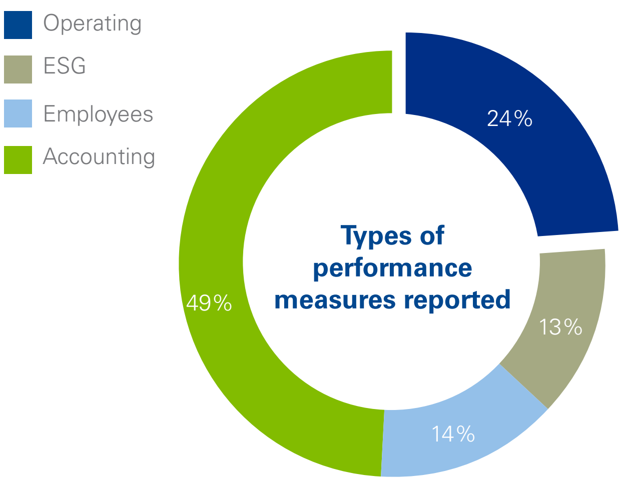
Many reports provide a narrow view of performance that is more closely aligned with compliance requirements than business value.

What we were looking for: different types of KPI

It would be a mistake to assume all KPIs have the same purpose – we suggest four broad categories that taken together can provide a more complete story of business performance:

- Context disclosures that provide detail on the business model in order that report users can assess what part of the business is potentially affected by a particular issue. For example, the identification of recurring and non-recurring customer contracts
- Risk indicators that enable report users to understand the extent to which significant but potentially remote issues are being managed. For example, the retention of key staff
- Progress indicators that demonstrate the extent to which the business strategy and plans have been implemented. For example, progress in expanding the business presence or customer base into new markets
- Reward indicators (covering both financial and operational outcomes) that demonstrate the impact that an issue or action is having on business outcomes that drive future shareholder returns. For example, customer acquisition or key market revenues

Many of these measures are most useful when presented in trend form covering a five year period to provide a basis for understanding the direction in which the business is moving.



Source: The KPMG survey of business reporting, 2014

What we found

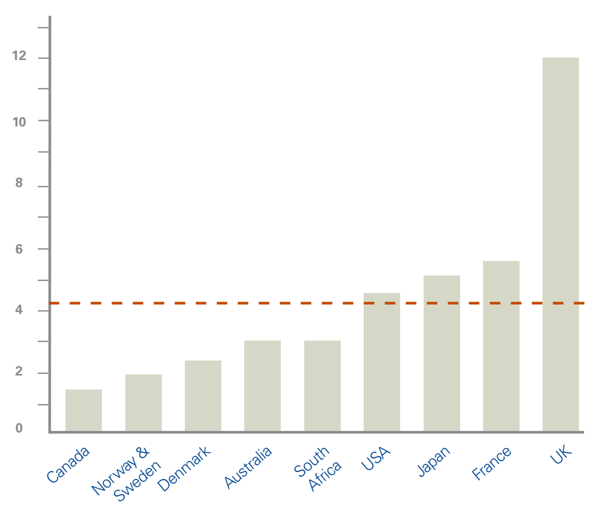
Our survey looked at performance measures given a degree of prominence in the annual report. We found most reports placed a heavy emphasis on explaining the financials, though the growing practice of providing employee / ESG disclosures was also apparent.

Many companies provide ESG (Environment, Social, and Governance) performance measures as a result of local regulatory requirements or voluntary compliance with disclosure frameworks such as GRI (Global Reporting Initiative). This forms the majority of non-financial information provided to investors. Whilst we recognise the importance of ESG factors in understanding a business's long term prospects, one would expect this to be as part of an overall picture of operating performance, rather than the dominant aspect.

The result is that there is a significant gap between the type of information used to manage the business, and the type of information being included in annual reports – under a quarter of the measures reported addressed operational issues. This is unfortunate as operating indicators will normally provide the most relevant leading indicators of performance.

With the exception of ESG measures, the majority of non-accounting measures took the form of reward indicators, focusing on outcomes rather than progress in addressing underlying issues that a broader range of measures might provide.

Number of operating measures reported



Source: The KPMG survey of business reporting, 2014

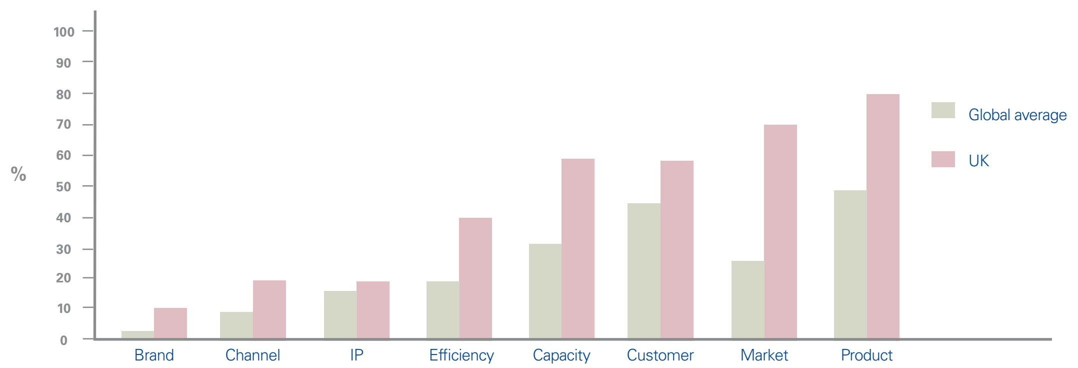
Practice in the UK

Reports in the UK provided significantly more non-ESG operating measures – some three times our average. In particular, UK companies were more likely to provide information on market size or share – with three companies reporting on relative market share in key markets. Information of this type is helpful both because it can show the extent to which the business is winning in its chosen markets, and also because it provides a basis for understanding the potential for expansion in targeted growth markets. Other UK companies provided information on overall market size, pricing trends, and expected sources of demand. UK companies were also more likely to provide data over product volumes or product sales mix – common globally in the natural resources sector but much less so elsewhere.

UK reporting is showing a lead in this area but we believe it still has some way to go in terms of the scope and relevance of the information being provided – operating performance information is still very much peripheral in most reports. Going forward, we expect that the FRC's guidance on preparing a strategic report will drive further disclosure of business-relevant operating measures, and should also encourage greater linkage of the measures provided to the underlying business model and strategy.

> "operating performance information is still very much peripheral in most reports"

Companies reporting operating measures



Source: The KPMG survey of business reporting, 2014

Use of operating KPIs

Area	Companies Reporting	Comment
Product	47%	A range of measures were provided by businesses, mainly in relation to product mix or volume. Additionally, 9% provided information on unit price, and 8% (in telecoms and natural resources) on product quality. Surprisingly, the least information was provided by engineering companies, with only 22% providing any product related measures.
Customer	42%	Customer metrics, including revenue per customer, wins and churn data are common in the telecoms industry (all but one of our telecoms companies reported on these, often in some detail). However, they are much less common in other sectors. In retail we saw some annual reports providing like for like sales (a common feature in investor presentations), and a smaller number reporting footfall statistics and loyalty scheme membership; In engineering, some companies reported on sales order book – an important statistic for contract-based businesses, and a few provided some detail on customer mix. A small number of businesses (total 7%) in the UK and Scandinavia provided leading indicators of customer performance such as customer satisfaction results.
Capacity	35%	This category covers measures of productive capacity or capacity enhancement. These measures are common in the natural resources sector, however, we had expected a higher level of reporting from the telecoms sector in particular, given the role that infrastructure investment plays in the business, and from the engineering sector where successful strategy development will often depend on having the right capacity in the right place.
Market	24%	A cross-section of companies from all sectors reported either a measure of market share or size (from which share could be calculated) based on external statistics.
Efficiency	21%	Almost half our natural resources companies reported on production efficiency but elsewhere efficiency data was much rarer, particularly in the engineering sector. A small number of companies also reported on utilisation levels.
Intellectual Capital	15%	It is no surprise that intellectual property is a common feature of pharmaceuticals companies' reports, with the profile of the product development pipeline generating particular focus. However, many other sectors depend on intellectual capital in a variety of forms, for example in the application of design ideas and know-how. We found that companies' investment in and competitive advantage from this is not generally being communicated through performance measures.
Channel	8%	Many businesses are dependent on intermediaries or resellers to access all or part of their end customer base. Sales through these channels often have different growth and margin drivers to the rest of the business, and therefore their business prospects need to be assessed separately. Few companies provide the information to enable this.
Brand	2%	Only two companies reported on brand – both by providing information on the growth of categories of branded products. Outside of this survey, we have seen other approaches to brand reporting such as recognition scores but the number of companies providing this type of analysis remains a small minority and the information provided is often at too high a level to address the key business performance drivers.

Source: The KPMG survey of business reporting, 2014

The performance reporting gap

Key long term drivers of performance aren't being reported

Are the key drivers of value being reported?

Earlier this year, KPMG's Audit Committee Institute asked nearly 1,500 audit committee members from around the world to identify the top three drivers of long term value that were most important to their business strategy[1]. Our reporting survey shows that many companies are not providing performance measures on these drivers. For example only 7% of the companies surveyed provided a measure of customer focus or satisfaction, yet 56% of audit committee members rank it in the top three drivers of performance. Many companies touch on these issues in their business reviews but it is done at such a high level that the comments might apply to any business in the industry. The lack of objective performance measures means it is difficult to identify those companies that are making genuine progress in managing their longer term prospects.

Asking the right question

One of the biggest challenges in drafting narrative reporting lies in identifying the right questions to answer. This requires an understanding of both the operational realities of the business and the perspective of an investor who is looking to assess the business value implications. In practice, though, the report is often prepared in isolation from both. It is extremely difficult to achieve a high level of business and investor relevance with today's function-led approach to reporting.

One of the early lessons from the implementation of Integrated Reporting in South Africa is that without organisation wide leadership, reports can quickly become disjointed collections of specialist subject matter that need to be slimmed down and refocused in subsequent years.

"it is difficult to identify those companies that are making genuine progress in managing their longer term prospects"

	Identified as a top three driver [1]	Companies providing a related operating KPI[2]
Operational efficiency	66%	21%
Customer Focus	56%	7%
Supply chain	42%	8%
Brand & reputation	42%	2%
R&D	41%	15%
Culture	37%	19%
Talent management	12%	17%

[1] KPMG's Audit Committee Institute: 2014 Global Audit Committee Survey

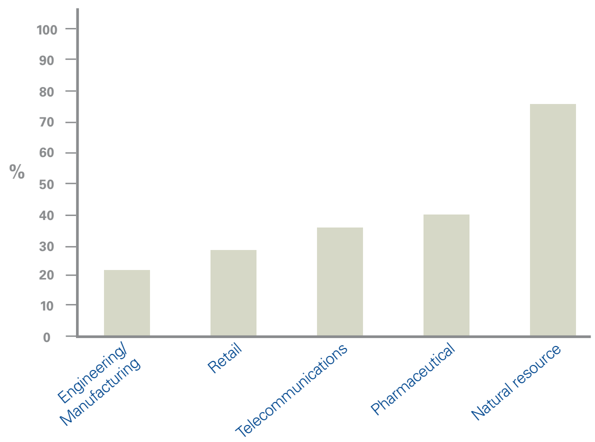
[2] The KPMG Survey of Business Reporting, 2014

Industry perspectives

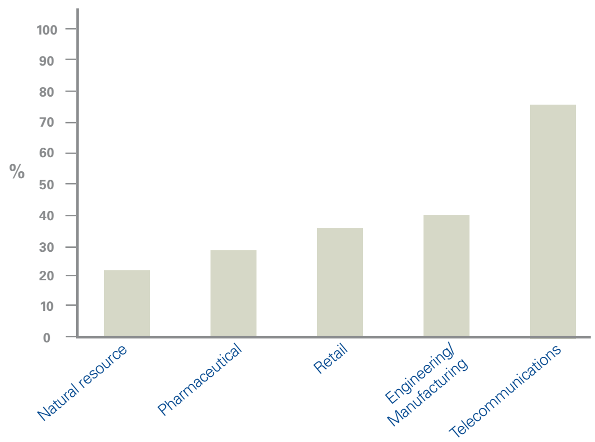
Learning from other sectors

Industry comparisons of Operating KPI reporting

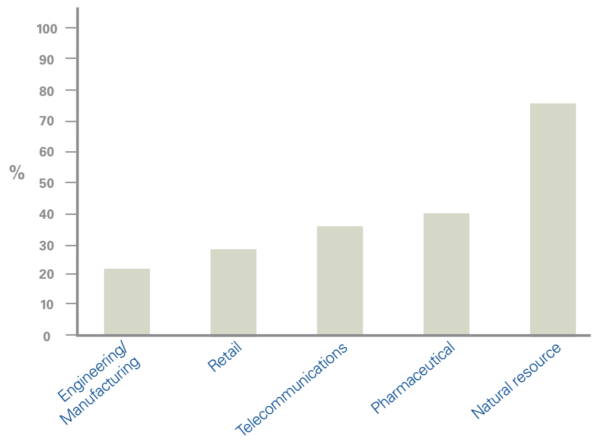
Companies reporting on product volume / mix



Companies reporting on Market Size/Share



Companies providing efficiency measure



Source: The KPMG survey of business reporting, 2014

Comment – Performance reporting in the Natural Resources Sector

We have noted particular interest in better reporting amongst energy and natural resources companies. They have represented a significant part (around 20%) of the IIRC's Pilot Programme, and companies in the sector in South Africa have made good progress with their reports. A key driver for this has been the need of these companies for large amounts of capital to fund long term investments. Positive accounting returns on these investments may take many years to achieve therefore these organisations need a more compelling way to tell the story of their investment propositions for the short, medium and longer term. They need to do this in a way in which financiers can understand and distinguish between the many other investment propositions with which they are competing.

At a time when the G20 are focused on how pension funds can be better mobilised for long term investment, it is important that business has the reporting in place to support this investment by providing trustees with a better understanding of their investment proposition.

Michael Bray
Asia Pacific Region Chairman, Energy and Natural Resources
KPMG in Australia

Adjusted earnings measures

Bridging the GAAP to link financial results to business performance

Different perspectives

Opinions on the use of adjusted earnings measures vary, with some seeing them as a contradiction of accounting standards. In practice, though, investors are increasingly looking to non-GAAP information in addition to GAAP information for insight into the companies they own. Looked at through this lens, they can play an essential role in linking the financial statements to explanations of business performance.

A more supportive regulatory approach

Some regulators' attitudes to adjusted earnings measures are evolving from a position of suspicion to one of constructive support. The most recent consultation, for example, comes from the European Securities and Market Authority, and seeks to enhance transparency and comparability rather than limit disclosures. We think this is the right approach – reporting rules should provide a starting point for explaining the business story, not to define the end point.

Choosing the most useful measures

Transparent disclosure of adjusted measures can help explain individual aspects of a company's past performabce through management's eyes. This may aid an understanding of the earnings run rate of the business – i.e. its ability to generate earnings tomorrow. This is of immediate relevance to anyone looking to assess future cash flow prospects.

However, on their own they are unlikely to answer all investor questions aimed at establishing a performance baseline for the business – including the mainstay of results presentations: 'how much of your cost saving initiative has come through this year's results?' Management commentary can build on GAAP and adjusted GAAP disclosures to address these more forward looking questions.

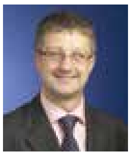
As practice develops, we encourage transparent disclosure of non-GAAP measures, including appropriate explanations and reconciliations of such measures (where possible to GAAP information) in order that shareholders obtain the maximum possible benefit from the enhanced disclosures.

UK practice

The UK has an established practice of providing adjusted GAAP data, with 80% of our companies surveyed providing some form of adjusted or 'core' earnings number. Companies in the UK have been doing this for a number of years – the figure five years ago was 70%.

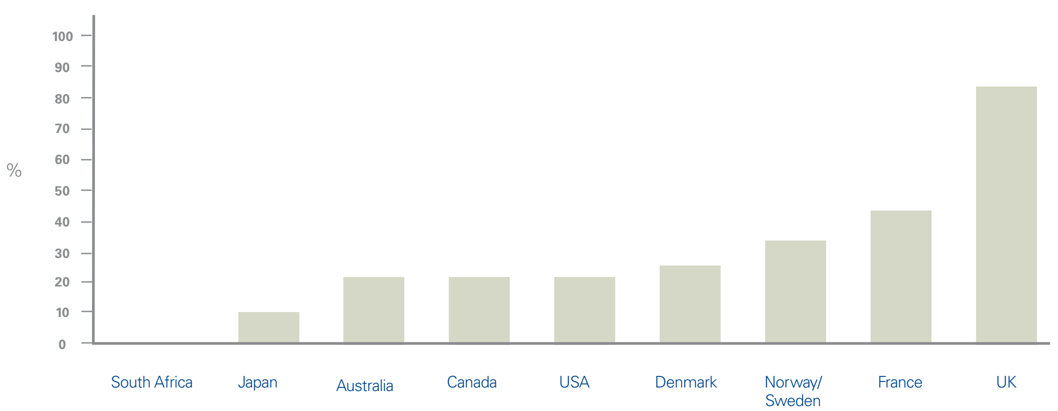
Comment – Non-GAAP measures in the UK

Properly explained non-GAAP measures supplementing and reconciled to GAAP where relevant can contribute towards a more efficient discussion of financial performance. They enhance rather than detract from the value of the financial statements.



David Littleford
KPMG in the UK

Companies reporting adjusted GAAP measures as a KPI



Note: Excluding re-presentation of GAAP measures such as EBITDA and prescribed non-GAAP measures used by South African companies for 'headline earnings' and 'adjusted headline earnings.'

Source: The KPMG survey of business reporting, 2014

Employee data

Employee matters can play a key role in driving business success, but the data provided in most reports offers only limited insight into how they are being managed.

A compliance led approach

Employee data comprises the single biggest category of non-financial performance reporting in our survey. Disclosure in this area has largely been driven by regulation. Does this demonstrate the value of imposed disclosures? Not necessarily, as it depends on the type of information being provided.

Some employee issues can be critical to future success. For example businesses in the natural resources sector are acutely aware that their license to operate is dependent on their ability to do so safely. Investors therefore need to know whether they are doing so and it is surprising that we are not seeing a higher proportion of natural resources companies reporting on this. But the issue of safety may be less relevant in other sectors. The danger of imposed disclosures is that they can create reporting clutter.

Providing investor-relevant information

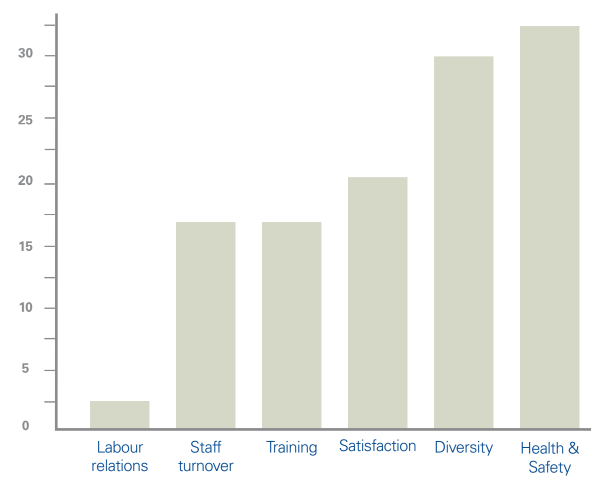
The danger is also that they encourage company wide disclosures that do not focus on the specific risks to the business.

Employee training and satisfaction are amongst the most common employee-related performance measures reported but it is often done so at a level where the most business critical information is obscured. The future of a technology company may depend on its ability to retain and motivate a core of highly skilled R&D staff, but its success in doing so will not be visible if it simply provides business-wide measures of staff retention.

> "company-wide disclosures that do not address the business-critical employee issues are of limited value to investors"

Employee related performance measures

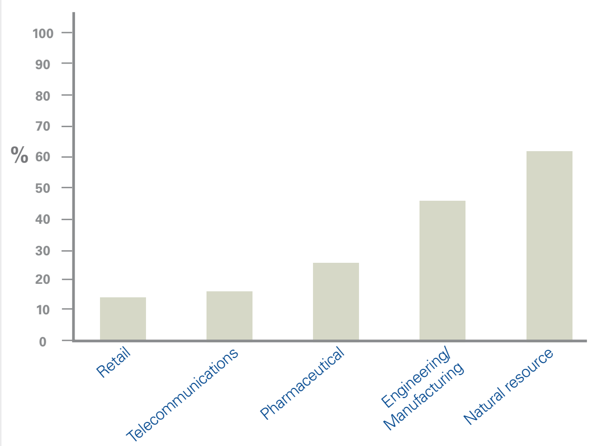
Companies reporting on employee issues



Source: The KPMG survey of business reporting, 2014

Industry reporting on health and safety

Companies reporting on Health and Safety



Source: The KPMG survey of business reporting, 2014

Environment Social and Governance

Despite the rapid growth of ESG reporting, it remains largely focused on meeting public policy and stakeholders needs.

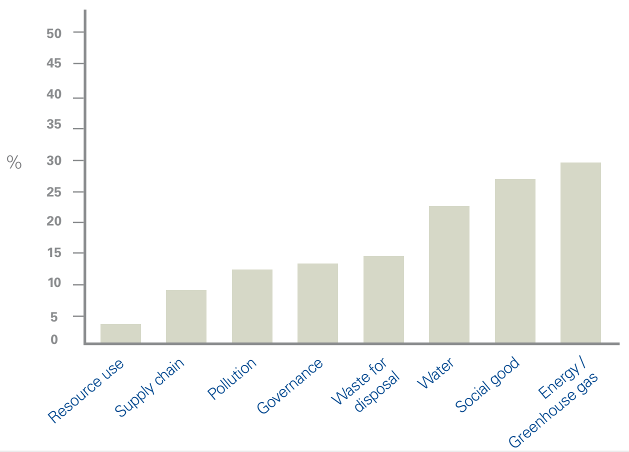
ESG reporting in the annual report

The provision of ESG information is now an established part of the corporate reporting agenda, though principally through a separate corporate responsibility report rather than in annual reports. There are two exceptions to this. Of the 190+ ESG measures we saw reported as KPIs in annual reports, some 60% came from French and South African companies.

We suspect that one reason for the limited focus outside of France and South Africa is that many companies still see their ESG reporting as being primarily of interest to stakeholders rather than investors. They therefore confine their ESG reporting to a separate document or as a separate section of the annual report. This is perhaps understandable as many ESG performance measures provide only the most general information to support investor decision making. The result is that overall we saw relatively little correlation between the ESG measures being reported by sector and the relative importance of this issue to the sector.

If annual reports are to connect with mainstream investors on ESG issues, they will need to provide more information that is directly relevant to an understanding of the business's earning prospects. The danger of public policy led disclosure initiatives is that they can distract report preparers from providing information on their most business critical issues in an investor-friendly manner.

ESG related performance measures – Proportion of companies reporting KPIs



Note[1]: We cover employee related measures on the preceeding page.

Source: The KPMG survey of business reporting, 2014

Connecting with investors

We suggest four different reporting approaches for ESG information depending on the relevance of the issue being communicated:

- Game changers – Issues and opportunities of core importance to the long term shape or viability of the business model. These might include the potential loss of an operating license, or loss of access to key resources.

  Identification of these issues together with the efforts and progress being made to manage them should be central to business reporting, not on the periphery. This means providing a basis for readers to understand the potential impacts, and the progress being made in managing them.

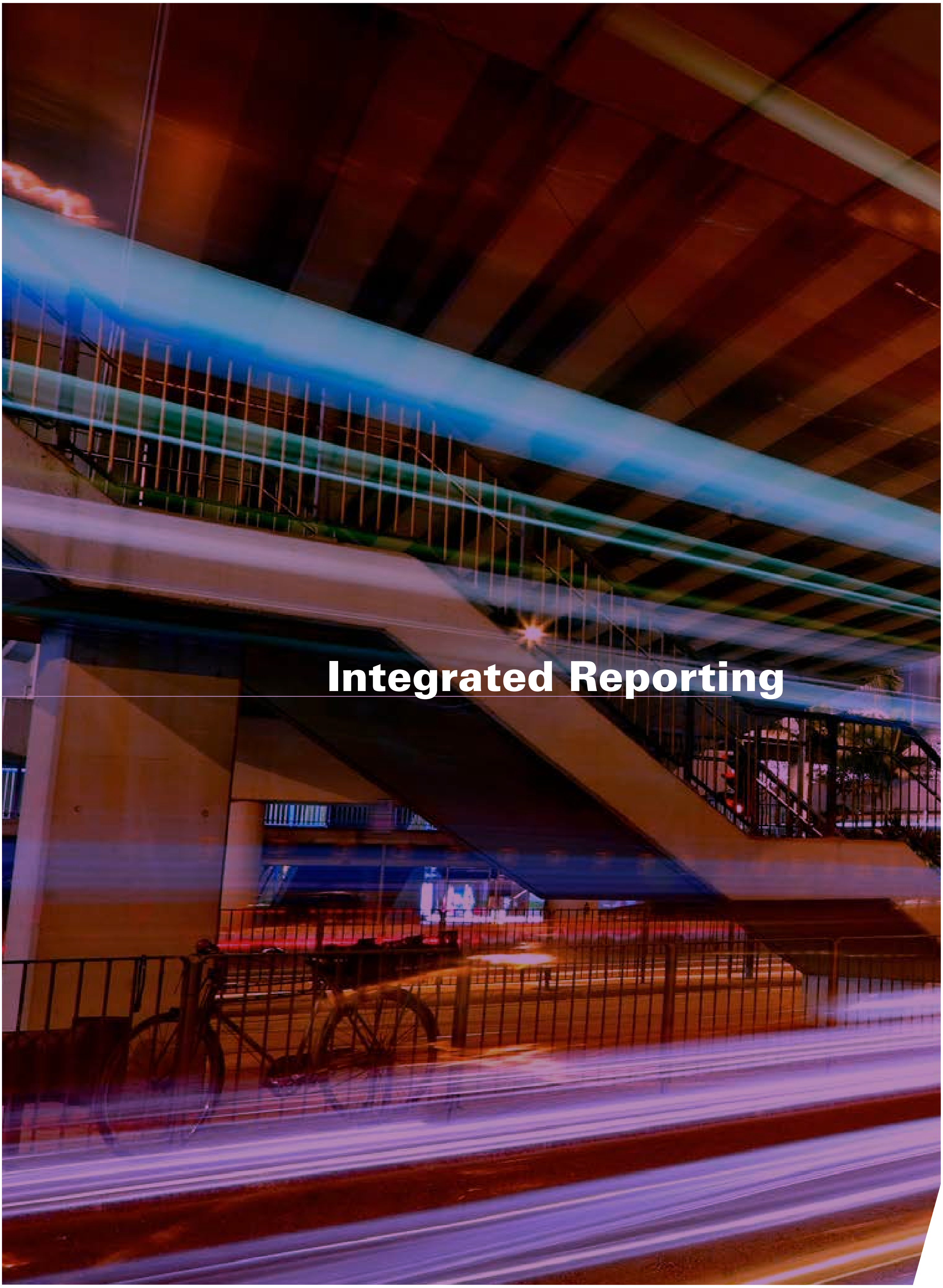
- Direct impact issues – these are less significant in terms of scale but still of interest because of their direct effect on the business's underlying performance.

  Readers will want to understand the material consequences and need specific information to do this. For example, reporting global carbon emissions does not help readers understand the potential impact of a localized carbon tax – regional emissions analysis is needed instead.

- Hygiene factors – there are some issues that, if not managed effectively, could severely damage business performance. Shareholders need to understand whether these issues are being well managed.

  For the most significant issues this may mean reporting risk indicators, such as levels of maintenance expenditure or customer satisfaction. For less significant issues, reporting may simply need to show there are adequate governance procedures.

- Other – some issues don't have a material bearing on business value but may interest specific stakeholder groups other than the Annual Report reader, or be required by specific reporting frameworks. Detailed information addressing these issues might be linked to and reported in a separate Corporate Responsibility Report if necessary. Including this information in an Annual Report may obscure more important messages.



Integrated Reporting

Integrated Reporting

The future of business reporting?

The Integrated Reporting Framework is an ambitious attempt to reshape the direction and focus of business reporting, aiming to provide investors with a more complete picture of business value by extending reporting beyond historical financial performance. Though its application to sustainability reporting is sometimes emphasised, Integrated Reporting is relevant to the communication of all aspects of business performance.

The framework is attracting particular interest from companies and regulators who are looking to improve the quality of narrative reporting discussion in the annual report – ultimately supporting a better dialogue between business and investors.

One of Integrated Reporting's key distinguishing features is its principles based approach which is designed to provide a basis for defining report content without imposing a list of compliance led disclosures that may obstruct rather than enhance the communication of business value creation.

The South African Experience

Our survey looked at how reporting has developed in South Africa since Integrated Reporting was adopted there. Combined with KPMG in South Africa's experience of companies implementing it, we draw three key conclusions on the first national experiment with Integrated Reporting:

1. Many South African reports provide a firm foundation for communicating business value drivers to investors. However, they will need to provide more relevant performance information if they are to connect with investor decision making. Key strengths of South African reports include the identification and focus on those business issues that are most relevant to business value, supported by linkage of issues across the report to provide a consistent and accessible narrative.

2. Applying the broader perspective of Integrated Reporting has been challenging but also a positive experience for many companies in South Africa. In particular, it has encouraged companies to take a hard look at the way in which they identify and monitor their most business critical issues.

3. South Africa was the only country in our survey to experience a fall in average report size. Whilst many year-one reports were significantly larger, the focus provided by Integrated Reporting has enabled companies to slim reports down in subsequent years.

The South African experience

Why we should be following developments in South Africa

Background

Integrated reporting became a requirement in South Africa for Johannesburg Securities Exchange listed entities with effect from years commencing on or after 1 March 2010 as a result of the King Code of Governance Principles for South Africa 2009 (King III). King III recommends that organisations should adopt Integrated Reporting, albeit on an 'apply or explain' basis. Guidance on the application of the requirement was provided initially by the Integrated Reporting Committee of South Africa who released a discussion paper: 'Framework for Integrated Reporting and the Integrated Report' in January 2011.

Integrated Reporting is now on the international agenda through the work of the International Integrated Reporting Council (which is chaired by Professor King). The IIRC has been attracting the attention of regulators, and has recently published its Integrated Reporting Framework. Its pilot programme has also attracted the attention of a number of leading global organisations.

Why Integrated Reporting matters internationally

The Integrated Reporting movement represents the first attempt to look beyond the traditional confines of the annual report that has gained traction within the reporting community. Its impact on South African reporting should therefore be of interest internationally.

It is worth emphasising the scale of ambition entailed in King III. Companies have taken time to adapt to the business-focused approach required, and they are working to develop their reporting systems to support the range of non-financial information required. In this context, it is important to see the developments in South Africa as an evolution towards the IIRC's vision for Integrated Reporting rather than the end point.

> "it is important to see the developments in South Africa as an evolution towards the IIRC's vision for Integrated Reporting rather than the end point."

An Integrated approach to reporting

Telling the business story

Integrated Reporting is built around seven key elements of content:

- business model;
- organisational overview and external environment;
- opportunities and risks;
- strategy and resource allocation;
- performance;
- outlook; and
- governance.

The Framework does not require the content elements to be discrete sections in the report. Rather, they should be seen as a high-level check to ensure that the report covers all of the relevant aspects of the business story.

Linking the elements

By linking content across these elements, an integrated report can build the story of the business from a basic description of the business model, through the external factors affecting the business and management's strategy for dealing with them and developing the business. This will provide a foundation to discuss the performance, prospects and governance of the business in a way that focuses on its most important aspects.

The linkage across the content elements will help to determine what should and, importantly, what should not be included in the report. For example, if a central part of the business strategy involves developing a particular market, then the logic of Integrated Reporting implies that the company should report on its progress in developing that market.

Focusing on the key drivers of business value

The result should be a report focused on the key drivers of business value – typically built around a thread of five or six key issues that run throughout the report. These should be the same issues that management is focused on in the operation of the business, and the same issues that should be driving investors' decision-making.

Integrated Reporting in practice

Integrated Reporting has not led to reporting bloat

Experience on the ground

Whilst report preparers have cited the ability to focus on the most material issues to the business, and better communication of business strategy, perhaps surprisingly for an external reporting framework, some of the most positive experiences with integrated reporting have derived from internal factors. In particular, organisations have appreciated the impetus to work across the different functions within the business provided by 'integrated thinking', and the opportunities identified for improving internal reporting.

Report volume

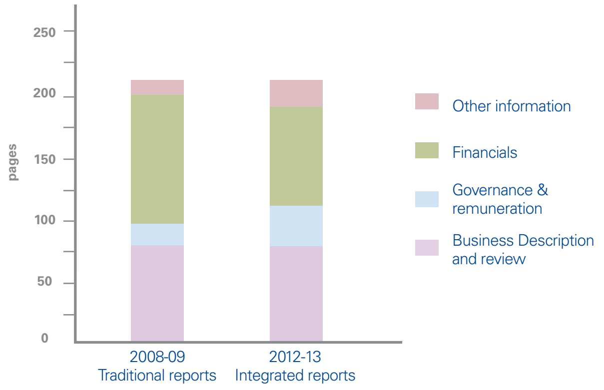
Many have expressed concern that Integrated Reporting could drive report sizes up – significantly. The experience in South Africa shows that adopting Integrated Reporting need not result in fatter reports – in fact, four of the ten companies surveyed are now producing substantially shorter reports.

Many South African companies have seen Integrated Reporting as an opportunity to take a hard look at their full reporting suite in order that it was not purely additive. One company in our survey had managed a 70+ page reduction in the size of their full financial statements.

The use of abbreviated financial information (with links to the full financials) has had a further impact on report size. Where the annual report takes this approach, our survey has included the full financial statements for the purposes of comparability.

Report size is one measure of clutter, but we see this as simply a means to improving the overall accessibility of reported information. Many South African reports provide excellent examples of how report readability can be improved. They have the inherent advantage that they are designed around the key business issues rather than compliance obligations, but they also make extensive use of referencing to enable readers to track issues across the report.

Annual reports in South Africa – before and after Integrated Reporting



Note: Includes separately published financial statements where relevant

Source: The KPMG survey of business reporting, 2014

Comment – Concise Integrated Reporting

The initial perception was that Integrated Reporting would lead to an increase in the size of reports due to the extent and depth of reporting envisaged. Although some reports did initially experience some bloat most organisations are seeing a distinct reduction in their subsequent reports. Organisations quickly realised the key to achieving concise reporting was to structure the report in the most logical manner and focus on the really material issues that the business faces.

Applying Integrated Reporting principles to identify and assess a consensus view of the material issues requires "integrated thinking" through involvement of all relevant disciplines in the business. Having effectively identified material issues the report needs to link these to the strategic response and in turn address the performance and prospects against the strategy.

Organisations with healthy risk management processes, well-articulated strategies and robust performance measurement systems tend to find it easier to achieve concise reporting. The bloat observed in some reports is often indicative of the lack of consensus and focus within the business on what the really important issues and initiatives are.

Mark Hoffman
Integrated Reporting
KPMG in South Africa

Connecting with investors

Not quite there – yet

There has been some disappointment that Integrated Reporting in South Africa has not made more impact with the investor community. Looking at the range of non-financial measures being reported in South Africa it is easy to see why – with the exception of certain narrow aspects of the business, the objective performance information being provided by South African companies is, for now, no wider than the average elsewhere.

We think this is a reflection of the way in which Integrated Reporting has evolved in South Africa, rather than evidence that it won't ultimately deliver better reports for investors.

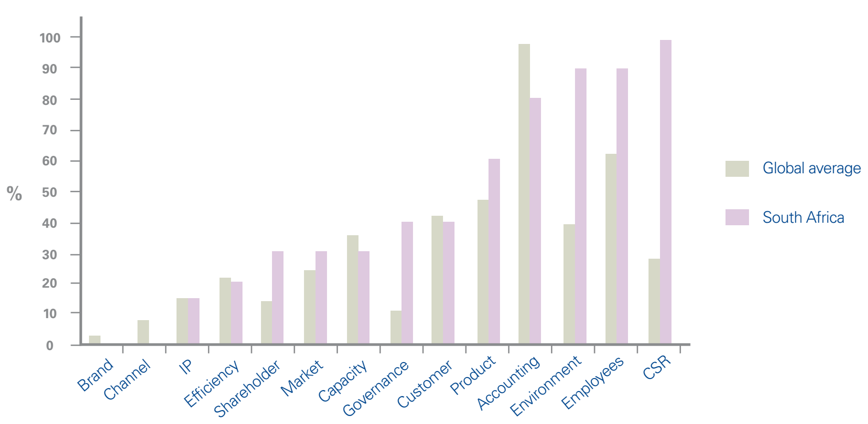
> "Once the final piece of the reporting jigsaw is added, we expect that investor interest will increase substantially."

The reason for this is three-fold:

- Firstly, the initial discussion paper produced by the Integrated Reporting Committee of South Africa placed a strong emphasis on reporting to a broad range of stakeholders (in contrast to the IIRC's Framework which is focused on reporting to providers of financial capital). The result has been that many reports do not attempt to provide the performance information that would be needed to support an investor's assessment of value creation.
- Secondly, there is a lingering assumption amongst many report preparers that investors are, in any case, only interested in current financial performance. It is therefore taking time for practice to extend to the most important operational aspects of the business.
- Thirdly, businesses have needed to develop their reporting systems to the point where they are able to report operating measures of performance externally.

It is therefore important to see current practice in South Africa as one step in the evolution towards investor-focused integrated reports. We believe that many of the reports now being produced provide a strong foundation for explaining progress in managing the key drivers of shareholder value. Once the final piece of the reporting jigsaw is added, we expect that investor interest will increase substantially.

Companies reporting non-financial performance measures



Source: The KPMG survey of business reporting, 2014

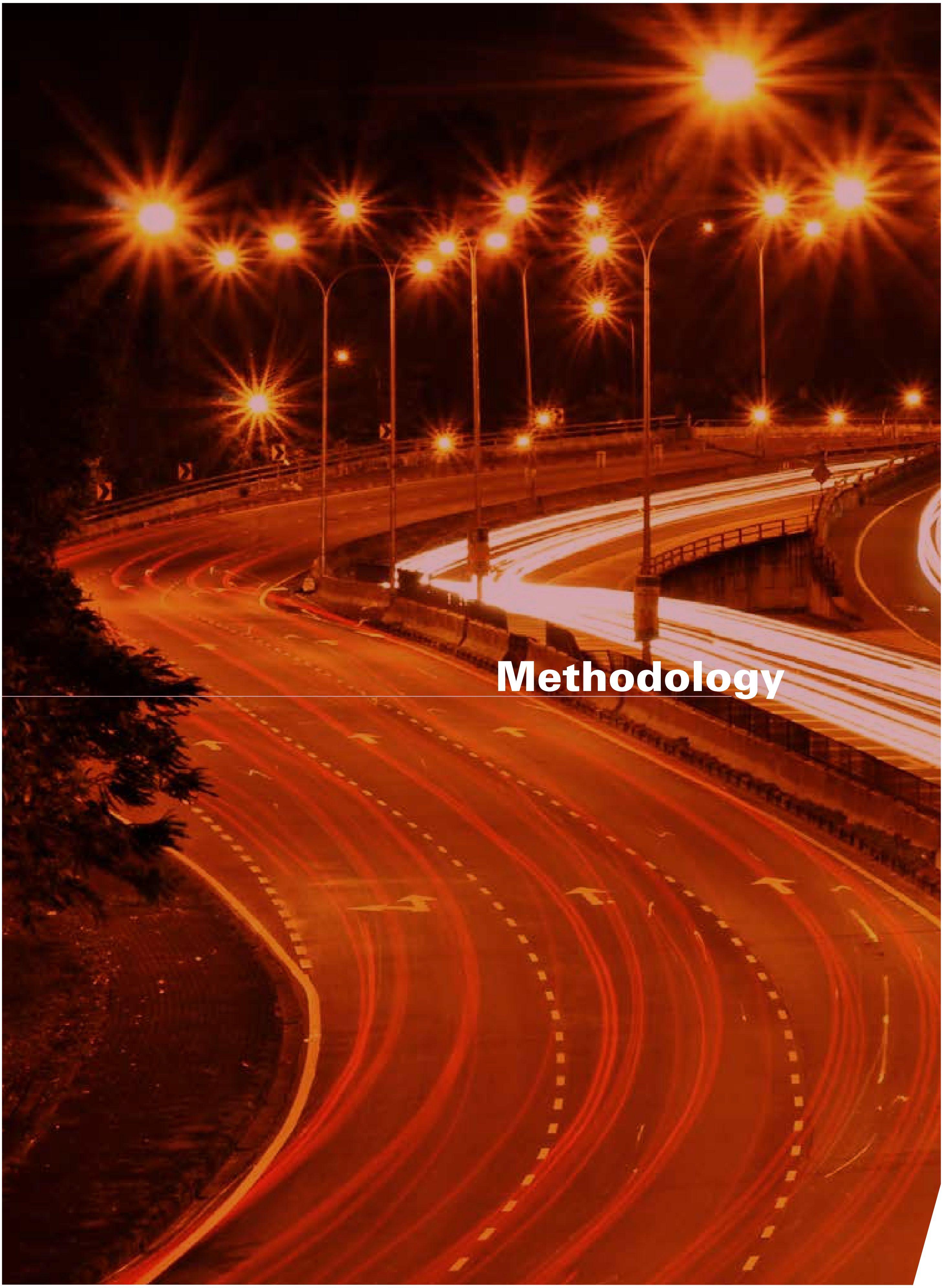
Comment – The relevance of Integrated Reporting to investors

Recognising Integrated Reporting as a business reporting process that is focused on the ability of the organisation to create value is key to its successful implementation in any organisation. The recently released Integrated Reporting framework has provided clarity that the purpose of the report is to deal with value creation as the central theme that should ultimately appeal to investors as well as a broader range of other stakeholders.

The most successful implementations of Integrated Reporting are typically led by senior management with full buy in from their management teams and board. These implementations are typically driven by a clear business case including more focused and streamlined internal and external reporting. In implementing Integrated Reporting many organisations have identified shortcomings in underlying processes, most commonly performance measurement and management against strategy execution.

With value generation and value sustainability as the underlying purpose and focus of the Integrated Reporting process it is clearly becoming a more investor centric report. As management buy into the Integrated Reporting process and the quality and depth improves the reports produced should provide a valuable insight into the business for investors.

Mark Hoffman
Integrated Reporting
KPMG in South Africa



Methodology

Methodology

Our survey looked at ten reports from each of the survey countries (Norway and Sweden on a combined basis). We looked at five broad sectors – engineering and manufacturing; retail; pharmaceuticals; telecoms; and energy and natural resources. The financial sector was excluded as the nature and range of reporting considerations and practice is less comparable than with other sectors. You can read more about the specific challenges facing report preparers in the banking sector in our publication: "Aligning Bank Reporting with Shareholder Value"

For each sector we selected one of the largest companies in the sector, and a smaller company (subject to a minimum market capitalisation of US$ 1 billion).

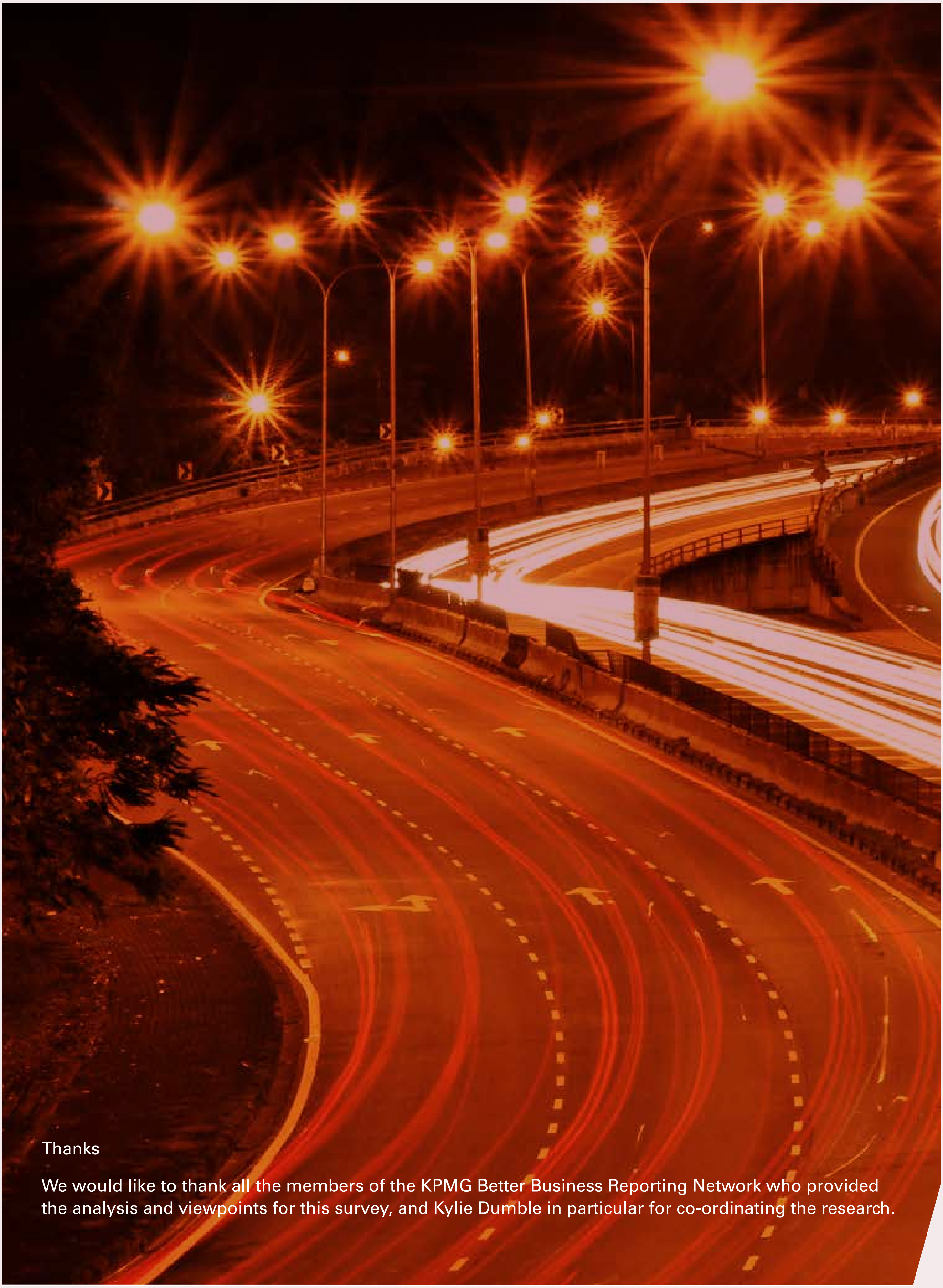
What we mean by an 'annual report'

The term annual report means different things in different countries. As a result, report content may differ due to national requirements as well as reporting practices. We have based our survey on each company's primary reporting document, as a minimum covering:

- Narrative reporting – covering quantitative and qualitative commentary on the business model, strategy, risks, and opportunities, and business performance / outlook;
- Governance reporting including directors' remuneration reports;
- The full financial statements – where abridged financial statements were presented, we have instead taken account of the separately published full financial statements;
- Any other information included in the primary reporting document

Sources of information used in the survey

Country	Primary source	Comment
Australia	Annual report	
Canada	Annual report	Also taking account of governance and remuneration disclosures in proxy statements
Denmark	Annual report	
France	Registration document	French registration documents also incorporate disclosures identified in the EU prospectus directive.
Japan	Annual report	Taking account of separate statutory securities filings where not included in the report
Norway	Annual report	
South Africa	Integrated report	Including separately published financial statements where the integrated report incorporates only the abbreviated financial statements
Sweden	Annual report	
UK	Annual report	
USA	10-K	Taking account of separately presented annual reports where these are referenced in the 10-K and governance and remuneration disclosures in proxy statements



Thanks

We would like to thank all the members of the KPMG Better Business Reporting Network who provided the analysis and viewpoints for this survey, and Kylie Dumble in particular for co-ordinating the research.

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