

Company Annual Reports

A framework for 'best practice'
in narrative reporting

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The Spirit of Narrative Reporting

“Communication with shareowners and other stakeholders is a priority for Cadbury Schweppes. This Framework provides a helpful checklist for assessing the issues and metrics we will need to present.”

*Sir John Sunderland, Chairman
Cadbury Schweppes*

“This Framework is a useful tool to assist directors of quoted companies in preparing their Annual Reports.”

*Richard Mallett, Director, Technical Development
Chartered Institute of Management Accountants*

“The Marketors Framework is a helpful tool to aid best practice in company narrative reporting”.

Chris Brinsmead, Company President, AstraZeneca UK Limited

“The changes in narrative reporting requirements are some of the most significant changes that have been made to company annual reports for years. They offer a real opportunity for directors to demonstrate to all of their stakeholders how they are managing their businesses to best effect. This Framework is an extremely valuable tool for those charged with producing these reports.”

*Professor Andy Neely, Professor of Operations Strategy and Performance,
Cranfield School of Management*

Narrative reporting in public company accounts has been developing fast in response to establishment pressures such as the new ASB Reporting Standard and Companies Act 2006. There is also a growing recognition that greater transparency has benefits for the companies themselves. It makes good sense that a company is well marketed in the City and that in turn requires better communications and transparency.

Narrative sections of Annual Reports, whether called Directors' Report, Reporting Statement, or Operating and Financial Review (OFR), are now expected to observe best practice as set out by the Accounting Standards Board¹, which retains the OFR terminology, and indeed must comply with S417 of the Companies Act 2006, both of which have these objectives:

- 1) the development and performance of the business entity during the financial year;
- 2) the position of the entity at the end of the year;
- 3) the main trends and factors underlying the development, performance and position of the business entity during the financial year; and
- 4) the main trends and factors which are likely to affect the entity's future development, performance and position, prepared so as to assist in assessing the strategies adopted by the entity and the potential for those strategies to succeed.

The narrative explanation of the development and performance of the company during the financial year reported should extend to those factors that are likely to affect the company's future performance. In essence, “the OFR shall set out an analysis of the business through the eyes of the board of directors”,² quantified where possible and comparable with immediate prior years.

The aim of this booklet is to summarize the recommendations in the form of a practical framework that can be used by boards and company secretaries to aid compliance and should be read in conjunction with primary documents. A scoring system is included (see page 11) to help evaluate compliance.

Framework Development

The Framework is the result of work conducted over three years in London Business School MBA student studies, under the guidance of Senior Fellow Tim Ambler and working in conjunction with the Think Tank of The Worshipful Company of Marketors. The objective was to create a proven framework that would enable companies to score their compliance with ASB guidelines objectively and unambiguously. Further tests were conducted to ensure that there was no undue scorer bias ensuring that independent reviewers should reach similar scores.

An original checklist, published in 2005, has been revised on the basis of research with analysts, scoring FTSE50 company annual reports and comparison with other scoring systems. The revised Framework was used in 2006 and 2007 to assess the narrative reporting within the annual reports of the top 50 quoted companies. The best practice was judged to be by Cadbury Schweppes and AstraZeneca respectively.

The response to the original Checklist was positive and study confirmed that a framework is useful for Company Secretaries and others preparing annual reports. The lead sponsor was the Worshipful Company of Marketors Charitable and Educational Trust. The Worshipful Company of Marketors is most grateful to The Business magazine for sponsoring the Award and this publication and to the Chartered Institute of Marketing and the Marketing Society for their endorsements.

INTRODUCTION TO THE FRAMEWORK

The Framework, which is the centre spread of this booklet, has three sections which are intended to give investors greater insight into the company's overall strategy and direction within the environment in which the company operates.

The three sections within the Framework are Context, Nature, Objectives and Strategies; Drivers of Development and Performance; and Financial Position. These are explained in detail on pages 5, 8 and 9 and 10 and 13 respectively.

Context, Nature, Objectives and Strategies

MARKET SERVED

- The company's major market(s) showing current market size with analysis by main business divisions/ product lines
- Market statistics, comparative figures and trends based on external sources

COMPETITIVE POSITION

- The competitive environment and position in major markets showing market share for each of the main business divisions/products
- Comparative figures and trends based on external sources

EXTERNAL FACTORS LIKELY TO AFFECT FUTURE PROSPECTS

- Significant features of the legal, regulatory, macro-economic, technological and social environment that influence the business in the main countries where the business is located.
- Trends, quantified information and relationship of factors to strategic goals

CORPORATE OBJECTIVES

- Corporate financial and non-financial long term qualitative and quantitative objectives
- Discussion of how objectives link to generating value

ECONOMIC OR BUSINESS MODEL

- How the business adds value, including: products, services, customers, business processes and distribution methods
- Business structure, overview of the main operating facilities and their locations

STRATEGIC EXPANSION/CONTRACTION

- Structural changes during the recent past and/or intended in future
- Discussion of the rationale of structural changes and how they will be implemented

KPIs/METRICS

- All key KPIs used by the Board to navigate the market and manage the business (the "Dashboard")
- Disclosure for each KPI of: performance to date and broad future expectation with comparative figures and trends
- Any changes in KPI calculation methods
- Comparison of KPI performance versus relevant market or competitors

Narrative Framework

Score*

CONTEXT, NATURE, OBJECTIVES & STRATEGIES

MARKETS SERVED, e.g. current size and future prospects

COMPETITIVE POSITION in markets served and future prospects, e.g. market share, ranking or position

EXTERNAL FACTORS LIKELY TO IMPACT FUTURE PROSPECTS, e.g. legal, regulatory, technological, economic, social, environmental

CORPORATE OBJECTIVES: financial and non-financial, quantitative and qualitative goals with some indication of timetable

ECONOMIC OR BUSINESS MODEL: how the business adds value, sources and usage of cash flow

STRATEGIC EXPANSION/CONTRACTION, e.g. diversifying or changing geographic markets served, product categories or customer types

KPIs/METRICS most used by the board to assess progress/performance: both financial and non-financial

DRIVERS OF DEVELOPMENT & PERFORMANCE

SOURCES OF CASH FLOW, e.g. profile of customers, number of end users/consumers, loyalty, churn, penetration, share of wallet

END USER CONSUMER ATTITUDES, e.g. satisfaction, perceived quality, intention to purchase

TRADE OR CHANNEL RELATIONS (where applicable), e.g. service levels, distribution, display, trade customer satisfaction

FACILITIES, SUBSIDIARIES, MARKETS SERVED AND DISTRIBUTION METHODS: key changes with impact on future cash flow

COMPETITIVE EFFECTS AND PERFORMANCE RELATIVE TO COMPETITORS, e.g. market share, relative pricing

DRIVERS LIKELY TO IMPROVE FUTURE PROSPECTS, e.g. marketing expenditure, sales force changes

DRIVERS LIKELY TO REDUCE FUTURE PROSPECTS, e.g. costs, impact of regulations

INNOVATION, e.g. number of new products, new products' revenue and margin as share of total, R&D investment

KEY STRENGTHS AND RESOURCES, e.g. reputation, brand equity, intellectual property, employees, capabilities, diversity

PRINCIPAL RISKS AND UNCERTAINTIES, e.g. how key internal and external risks are being addressed

RELATIONSHIPS WITH OTHER STAKEHOLDERS: which are most important, why?, implications, risks for cash flow

FINANCIAL POSITION ANALYSIS AND EXPLANATIONS

ACCOUNTING POLICIES, e.g. those necessary to understand the performance and financial position changes

CAPITAL STRUCTURE: nature, rationale, short/longer-term plans

TREASURY POLICIES: analysis and explanation of cash-related matters

CASH FLOWS, e.g. probable cash requirements, where segmental cash flows are out of line with profits

LIQUIDITY, e.g. working capital, current assets, current and prospective borrowing requirements

PROFITABILITY, e.g. sales volume, turnover, gross margins, profit ratios

TOTAL (MAXIMUM SCORE IS 120)

* For scoring methodology see Page 11

Drivers of Development and Performance

This section specifically considers customers, as the primary source of cash flow, competitors and internal resources, as well as employees and intangible assets such as brand equity or reputation. Terminology differs by sector but these considerations apply in all companies whether direct to consumer or business-to-business. Where the company is dealing directly with the final consumers, e.g. the retail sector, the section addressing channels, or intermediate customers, will not be relevant.

SOURCES OF CASHFLOW

- Profile of customers, reasons for buying, number of end users/consumers, loyalty, churn, penetration, share of wallet
- Externally sourced KPIs/statistics, comparative figures and trends

END-USER CONSUMER ATTITUDES

- End-user/consumer awareness, attitudes and beliefs such as satisfaction, perceived quality, intention to purchase
- Responses to communication campaigns
- Externally sourced KPIs/statistics, comparative figures and trends

TRADE OR CHANNEL RELATIONSHIPS

- Changes in trade or channel relationships such as service levels, distribution, display, trade customer satisfaction
- Discussion on factors and trends in the context of strategic objectives
- Externally sourced KPIs/statistics, comparative figures and trends

FACILITIES, SUBSIDIARIES, MARKETS SERVED AND DISTRIBUTION METHODS

- Discussion of any key changes with their impact on cash flows and capital employed during the review period and in future.

COMPETITIVE EFFECTS AND PERFORMANCE RELATIVE TO COMPETITORS

- Competitive advantage and performance relative to competitors
- Discussion on factors and trends in the context of strategic objectives
- Externally sourced KPIs/statistics, comparative figures and trends

DRIVERS LIKELY TO IMPROVE OR REDUCE FUTURE PROSPECTS

- Discussion of factors and trends in the context of strategic objectives
- Externally sourced KPIs/statistics, comparative figures and trends

INNOVATION

- Current levels and planned future of investment and development of new products
- State of new product pipeline and products launched during period under review
- Expected success rate and benefits
- Externally sourced KPIs/statistics, comparative figures and trends

KEY STRENGTHS AND RESOURCES

- Description of tangible and intangible key assets such as corporate reputation and brand equity, natural resources, employees, research and development, intellectual capital, licenses, patents, copyright and trademarks
- Discussion on how key resources are measured and managed as part of business model
- Externally sourced KPIs/statistics, comparative figures and trends

PRINCIPAL RISKS AND UNCERTAINTIES

- Identification, methodology for evaluation and management of principal risks and uncertainties
- Relevance to the business and relationship to strategic goals
- Quantification and comment on how are they changing decreasing/increasing

RELATIONSHIPS WITH OTHER STAKEHOLDERS

- Description of principal relationships with other stakeholders likely to affect future prospects (customers, suppliers, employees, contractors, lenders, creditors, regulators and strategic alliances)
- The extent to which these relationships may affect performance
- Discussion of policies and extent of success of policies

Financial Position

The final section amplifies and explains, to the extent necessary, the financial statements and notes. Broad capital structure and treasury policies should be outlined especially where material changes have taken place or are envisaged.

ACCOUNTING POLICIES

- Impact of any unusual accounting policies on the financial statement, especially those that require judgment in their application and to which results are sensitive
- Changes during the year or anticipated in future

CAPITAL STRUCTURE

- Comments on balance between debt and equity, maturity profile of debt, type of capital instruments used, currency, regulatory capital and interest rate structure
- Discussion of nature and rationale in capital structure
- Description of any distributions, capital raising and share repurchase
- Discussion of short / long term planes to support strategy
- Comments on receipts from/returns to shareholders

TREASURY POLICIES AND OBJECTIVES

- Discussion of any changes during the year or expected
- Explanation on the purpose and effect of major financing transactions undertaken
- The effect of interest costs on profits and potential impact of changes in interest rates

CASH FLOWS

- Discussion of any significant changes in inflows and outflows during the year and expected in future, at company and any major sub-unit level

LIQUIDITY

- Ability to generate sufficient cash to meet known or probable cash requirements and to fund growth
- Plans for making use of any excess cash
- Other current and prospective liquidity issues including: level of borrowings, the seasonality of borrowing requirements and maturity profile of both borrowings and undrawn committed borrowing facilities

- Ability to fund current and future operations and stated strategies.
- Internal sources of liquidity and restrictions on free transference of funds across parts of the group: exchange controls and taxation consequences of transfers
- Covenants in financing contracts and related past or future negotiations on those.
- Breaches of covenants: real or expected and details on measures taken or proposed to resolve the situation

PROFITABILITY

- Changes in main items in the Profit and Loss Account explaining changes in profitability including any one-off item charges such as restructuring costs, extraordinary costs, etc.

Scoring Narrative Reporting Practice

Score 5 for each line that completely meets the ASB guidelines as summarized above and 0 for any line that completely fails to do so. Score 4 for “best current practice”. As a guide to this, the top 5 FTSE50 companies, in compliance terms, scored an average of 3 but 4 or 5 on high scoring lines.

If your narrative rates as well as the annual reports you most admire, score it a 4 but if it is “average good practice” then give it a 3. If the narrative superficially meets the guidelines but in reality it provides no useful information, score it 1. If it is better than that but still below “average good practice”, score it 2.

We understand the reluctance to provide hostages to fortune through excessive candour. On the other hand, confidentiality is often over-claimed as a reason for non-disclosure. If the information is either known to competitors or not useful to them, e.g. past results, then confidentiality should not be a reason for non-disclosure.

On an item by item basis, companies mostly fail to provide adequate information about their potential markets, competitive position, consumer’s attitudes and trade or channel relations. On the other hand, companies are mostly good at explaining profitability, describing their businesses and describing their principal risks and uncertainties.

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The Business
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The Chartered Institute of Marketing
www.cim.co.uk



The Marketing Society
www.marketing-society.org.uk

Further information available at:
www.marketors.org