Discussion paper

Introducing a Management Review (MR) in the annual reports of listed companies in Sri Lanka
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Discussion paper – Introducing a Management Review (MR) in the annual reports of listed companies in Sri Lanka

(A) Introduction

- In June 2006, CIMA Sri Lanka submitted a proposal to the CSE/SEC to initiate a project to study the feasibility of introducing an Operating and Financial Review (OFR) style Management Review (MR) in the annual reports of listed companies in Sri Lanka.
- Following approval of this proposal by the CSE Board, the CSE requested CIMA to appoint a Committee consisting of the key stakeholders to study and report on this subject.
- In July 2007, CIMA Sri Lanka in consultation with the CSE appointed a committee tasked with this mandate (List of Committee Members given in Annex 2). The Committee was supported by the Technical Committee of CIMA Sri Lanka.

(B) The committee process

The committee commenced work in August 2007 and its activities included:

- periodic committee meetings which deliberated upon the issues/concerns pertinent to the MR from a Sri Lankan perspective and stakeholder input on the subject.
- review of literature and publications on international best practice with regard to narrative reporting.
- commissioning and reviewing a research study on Sri Lankan annual reports with regard to narrative reporting.
- organising a meeting with the ‘users’ of annual reports/investors to ascertain their views/input on the content of the MR.

(C) Rationale for the MR

There is growing recognition internationally of the importance of narrative reporting to be considered as an integral part of financial reports. This is evidenced by the requirements and regulations governing narrative reporting in different jurisdictions: ‘Operating and Financial Review (OFR)’ and now the ‘Business Review’ in the UK, ‘Management Discussion and Analysis’ in the USA and Canada, ‘Management Reporting’ in Germany and the IASB discussion paper and movement towards developing non-mandatory guidance for the ‘Management Commentary’. In this discussion paper, the term ‘MR’ will be used for narrative reporting.

Research on local annual reports show that nearly half the listed companies in Sri Lanka do not publish a MR or equivalent, although some elements are dealt with in the chairman’s review and different parts of the report. Where an MR is published, they tend to differ greatly in scope and content in the absence of local guidelines on the subject.

The annual report is the premier business reporting document of a listed company, which is relied upon by the shareholders/investors to get detailed
information on a company’s performance, development, position and its value creating activities. The financial statements, contained in the annual report, form the core of financial reporting. While the financial statements and the related disclosures have developed significantly over time, they are by themselves not sufficient to address the full requirements of financial reporting and to provide investors with all the information they require.

The MR is therefore, intended to complement and supplement the financial statements, providing insights into a company’s performance beyond the financial statements. It is an endeavour to improve the quality of financial reporting to investors by providing inter alia, qualitative information on how companies create value and the key drivers of a company’s value generating activities and risks associated therewith and to assist members/investors to assess the strategic direction of the company and the potential for its success.

In the process of the committee’s deliberations and consultation, while there was general acknowledgement that guidance on the MR would indeed be useful and desirable in the Sri Lankan context, there was a wide spectrum of views on what the content of the MR should be. On one end of the scale, was the view that the annual reports already say too much and the MR will place the 235 public quoted companies presently operating in Sri Lanka at a distinct disadvantage viz-a-viz the substantially larger number of their unlisted competitors who are not obliged to publish an annual report. At the other end of the scale was the view that, the MR disclosures should in fact, be viewed positively as an ‘opportunity’ rather than as an ‘obligation’ and as disclosures aimed at value creation for the business, thereby attracting greater investor interest, which in turn will develop the local capital market, an imperative for sustainable growth. The committee also found that, generally the preparer’s perspective on the MR content tended to be different to the user’s/investor’s perspective, with preparers generally favouring ‘a lower level of disclosure/voluntary approach’ and users advocating ‘greater disclosure/a mandatory approach’.

The committee recognised the vital need to customise the content of the MR, to suit the operating context of a developing country such as Sri Lanka, particularly taking into consideration the following:

- the relatively small capital market – listed companies constitute a small percentage, viz-a-viz the total corporate sector
- preponderance of SME’s and micro entities and conglomerates, which tend to be relatively closely held as opposed to being broad based
- lack of reliable and independent indices and market data
- high economic volatility resulting in an operating environment of greater risk and uncertainty
- strains imposed by existing regulations – new companies Act, Sri Lanka Accounting Standards, Listing Rules and Corporate Governance Code, etc.

In this context, the committee saw merit in the argument that cautions against the disclosure of sensitive or strategic information by listed companies. As such, it was felt that some of the disclosures recommended in the ASB
reporting statement on the OFR, such as ‘key performance indicators’, ‘future targets’ and ‘strategies’ may not be practical nor appropriate in the Sri Lankan context, at this point of time.

The challenge therefore has been to strike a ‘balance’ between the international narrative reporting best practice guidance on the one hand and legitimate local contextual concerns on the other. The committee’s approach has been to adapt/customise the narrative reporting content to suit the Sri Lankan context based on the overriding principle of whether it meets the information requirements of members/investors and whether benefits outweigh the costs. In recognition of this, even though the MR is proposed only as ‘recommended practice’ and will not have mandatory force, it has been decided to ‘scope out’ small listed companies from the MR recommendation.

(D) Procedure for adoption of the MR guidelines

The committee recognises that adoption of the guidelines on the MR should follow due process with maximum opportunity provided for extensive consultation/discussion among all the stakeholders involved, thereby ensuring the required ‘buy in’ of both users and preparers of Annual Reports. Accordingly, the Committee proposes the adoption of the following steps, in this regard:

**Step one** - after approval by CIMA Sri Lanka Council, to forward to the CSE as a ‘Discussion paper on introducing a Management Review in the annual reports of listed companies’.

**Step two** - CIMA Sri Lanka Division, in co-ordination with the CSE, to issue as an ‘exposure draft’ and invite comments from all the stakeholders (time scale for comments – 30 April 2009)

**Step three** - at the end of the comment period, CIMA Sri Lanka Division to organise an ‘open forum’ to provide a further opportunity for discussion/comment on the ‘exposure draft’.

**Step four** - revise/finalise the MR guidelines based on consideration of the comments/input received during the ‘comment period’.

**Step five** - to issue as recommended practice on the Management Review.

Allowing a 6 month time frame for the consultation/review process, it should be possible for MR guidelines to be targeted to become effective for financial years commencing on or after 1 April 2009.

(E) Acknowledgements

The committee wishes to place on record its sincere appreciation to all those who assisted in the committee’s deliberations/work in numerous
ways. In particular, the committee wishes to acknowledge the contribution made by the following:

- The technical committee of CIMA Sri Lanka Division
- The technical director of CIMA Global, UK.
- The research team from CIMASS for their research input on narrative reporting by local listed companies.
- The stockbrokers, fund managers and investors for their valuable input.
- The CIMA Divisional secretariat for their coordination and administrative support.

(F) References


ii. IASB Paper on ‘Management Commentary’ Oct 2005. (Website ref www.iasb.org)

iii. Deloitte Publication ‘Surveying OFR’s’ ‘Written to Order’, ‘Write to Reason’ (Website ref: www.deloitte.com)

iv. ‘The OFR, a checklist for companies’ version 1.1 (Website ref: www.ofrchecklist.co.uk)

v. Black Sun Corporate Reports, “The Complete FTSE 100. Where are we now?” (Website ref www.blacksunplc.com)

vi. Radley Yelder Publications: “How does it stack up? Spring 2007, Narrative Reporting Content of the FTSE 100”

Discussion paper – Management Review (MR)

In developing this paper, the committee has studied several publications on narrative reporting (wide list of references attached). The UK Accounting Standards Board’s ‘Reporting Statement: OFR’, published in January 2006 and IASB’s discussion paper on ‘Management Commentary’ of October 2005, formed the primary reference documents for definitions, principles and disclosures referred to in this paper. In its endeavour to achieve a balance, the committee has adopted several key principles and disclosures recommended in the said documents, which the committee feels is relevant and appropriate to the Sri Lankan context at this point of time.

Objective

To recommend guidelines for introducing a Management Review (“MR”) in the Annual Reports of listed companies in Sri Lanka.

Scope

The MR is intended for listed companies, except ‘small companies’, to be adopted on a voluntary basis. Accordingly, the MR is to be regarded as recommended practice intended to have persuasive as opposed to mandatory force.

‘Small Companies’ are listed companies that fall below/outside the qualifying thresholds for Specified Business Enterprises (SBE) referred to under ‘other companies’ as per the Sri Lankan Accounting and Auditing Standards Act No. 15 of 1995 and regulations made under the said Act (Gazette extra ordinary No. 1074/7 refers).

Definition and key principles

(a) A MR is a narrative report, provided in the annual report, analysing the main trends and factors underlying the performance, development and position of a company during the financial year covered by the financial statements, and which are likely to impact the company’s future development, performance and position.¹

(b) MR should provide a fair review of the business of the company through the eyes of the directors/management and focusing on matters that are relevant and material to the interests of members.²

(c) The MR should be comparable over time and should complement as well as supplement the financial statements in order to enhance the overall corporate disclosure and give a ‘balanced’ and ‘neutral’ view.³

¹,²,³: Adapted from Reporting Statement–Operating and Financial Review, Accounting Standards Board – January 2006)
MR Reporting Guidelines

(a) MR in respect of group annual reports – in the case of annual reports of a group of companies, the MR should give greater emphasis to matters material and relevant to the group as a whole. Each listed individual subsidiary is expected to include their own MR, in their respective annual reports.

(b) The MR may contain an appropriate disclaimer/safe harbour provision to protect the directors, subject to the companies’ act, in respect of disclosures made in good faith particularly with regard to forward looking information provided therein, and may also contain wording to the effect that the MR has been prepared solely to provide additional information to shareholders as a body and should not be relied on by any other party for other purposes.\(^4\)

\(^4\) (Deloitte Publication: write to reason – Illustrative OFR – pg 35)

(c) Directors may withhold information of a proprietary or a sensitive nature or about future developments/matters under negotiation, if their disclosure would, in the opinion of the directors, be seriously prejudicial to the interests of the entity.

(d) The MR does not require to be audited, however, the auditors are expected to comment, if the MR contains statements, contradictory and not consistent with the audited accounts.

(e) The companies publishing a MR according to these guidelines may include a statement to this effect.

(f) In order to avoid duplication of the information provided in different parts of the Annual Reports, the MR is expected to replace the ‘Management Discussion and Analysis’ (or equivalent), ‘Financial Review” (where applicable) and ‘Risk Analysis’ sections of a typical annual report.

Likewise, if any part of the recommended content of the MR is mandated to be disclosed elsewhere in the annual report (eg: by the companies act, the accounting standards or by any other regulation), such content may be excluded from the MR, subject to maintaining the logical flow of the MR and adequate cross referencing being provided.

(g) The MR should pay special emphasis to the effective presentation of information in a user friendly business – focused manner employing modern reporting/presentation techniques including tables, graphs and charts. Guidance in this regard is available in the multi stakeholder initiative; the ‘Report Leadership’ publication (www.reportleadership.com).
**MR content/disclosures**

The Committee is of the view that a principles based approach as opposed to a rules based one would be more desirable with regard to the content/disclosures of the MR. In this regard, the broad MR headings will include the following:

(a) The nature, objectives and strategic direction.
(b) Financial review.
(c) Principal risks and uncertainties.
(d) Current and future performance and trends.

The committee feels that the board of directors/management of a company are best positioned to determine the detailed content, tone and presentation of the MR and that there is no ‘one best way’ of presenting the MR. Nevertheless, it is felt that, it would be useful to produce a checklist of recommended disclosures of a MR by way of providing guidance in this connection.

Please refer to Annex 1 for illustration of a checklist of recommended content/disclosures of a MR.
A. The nature, objectives and strategic direction

(a) The MR should include a description of the business and the external and regulatory environment in which it operates as context for the analysis of performance in a given financial year and the financial position at year end. This would inter alia include a broad description of:

i. The industry/industries in which the entity operates

ii. Its main products, customers, business processes, distribution methods and main facilities and locations.

iii. The structure of the business and its economic model.

iv. Major markets and the competitive environment.

v. Key Drivers of performance of the business and creation of value.

vi. Legal, regulatory, macro economics and social environment that impacts its business.

(b) The MR should discuss the key financial and non-financial objectives of the business to preserve or enhance value over the longer term.

(c) The MR should mention the strategic direction being followed towards achieving the objectives of the business.

B. Financial review

The MR should contain a detailed financial review and an analysis of the financial performance and position of the entity including:

i. **Profitability**, sales growth, gross margins, key profit ratios.
   - changes in accounting policies during the year and the impact thereof
   - the financial impact of ‘fair value’ adjustments, if any, on the income statement
   - discussion on any major variances between quarterly published accounts and the annual accounts

ii. **Segmental analysis** and the contribution of each major business segment to the ‘top line’ and ‘operating profits’ of the business and future trends thereof.

iii. **Capital structure** of the entity and major changes therein.
iv. **Cash Flow** - discussion on the cash inflows and cash outflows during the financial year and future trends thereof and the key treasury policies adopted by the business.

v. **Capital expenditure** incurred/committed and how these will be funded and also information on any major investments/transactions including mergers/acquisitions and diversification projects undertaken during the year or intended in the near future.

vi. **Liquidity** position indicating ability to fund current and future operations, expansion and debt servicing.

C. **Principal risks and uncertainties**

(a) The MR should include a description of the principal risks and uncertainties facing the entity together with a commentary on the management’s approach to mitigating them.

(b) Information on persons with whom the entity has contractual or other arrangements, which are essential to the business of the entity, to the extent feasible.

D. **Current and future performance trends**

(a) The MR should describe the significant features of the performance and development of the business during the financial year, focusing on the business segments that are relevant to an understanding of the overall business performance and development.

(b) The MR should analyse the main trends/factors that directors consider are likely to impact future prospects.

(c) Information and policies with regard to the following:
   i. environmental matters (including the impact of the Company’s business on the environment)
   ii. the company’s employees
   iii. social and community issues

(d) Confirmation of going concern status.

Note:
If any part of the recommended content of the MR is mandated to be disclosed elsewhere in the annual report, under the companies act, the accounting standards or by any other regulation, such content may be excluded from the MR, subject to maintaining the logical flow of the MR and adequate cross referencing being provided.
Annex 2

The commitee

Lalith Fonseka - Chair
Shanthikumar Sadanandan, Past President CIMA Sri Lanka
Dulsiri Andradi, Chair – Technical Committee, CIMA Sri Lanka
Manil Jayasinghe – Partner, Ernst & Young
Renuke Wijayawardhane, Representing CSE
Thanuja Aluwihare, Representing CSE
Surana Fernando, Representing SEC
Ruvini Bandara, Technical Director, ICASL
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Nilanthi Sivapragasam – Director Aitken Spence PLC - (Alternate:Romaine Nicholas)
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