Market value

Professional investors' views about financial reporting in Canada

A report co-sponsored by CPA Canada, PwC and Veritas Investment Research

Highlights

Key takeaways

A valuable toolbox

When making investment decisions, investors value formal financial reports such as the financial statements, management's discussion and analyses (MD&A), annual information forms (AIF) and management proxy circulars. Generally, investors reported being satisfied with the information they receive from companies. Nevertheless, investors also noted areas where improvements should be made to accounting standards or securities regulations. While initially skeptical about Canada's transition to International Financial Reporting Standards (IFRSs), investors' experience with the first year of IFRS reporting has resulted in most being comfortable with the changeover.

Communicating complexity

Financial reporting has become significantly more complex over the last several years, and in some cases, companies seem to struggle with effectively and concisely communicating such complexity to stakeholders. For example, few investors were aware of the importance of transactions that are processed through Other Comprehensive Income, even though these transactions may have significant implications for the company. Preparers should carefully consider how best to plainly and succinctly communicate the impact of such transactions to ensure that investors are properly informed. Overall, the use of less boilerplate language in financial documents was a repeat request.

One report

Many investors believe that all of a company's formal annual financial reporting should be presented in a single omnibus report to avoid duplicate information across documents and concentrate all data for ease of searching. A significant minority, however, prefer the current multi-report approach, which in their view provides more timely information.

Non-GAAP measures

While nearly all investors appreciate non-GAAP measures to better understand managements' insights about performance results, stakeholders also want more comparability across reporting periods and between peers. The desire for comparability extends to information generated by data consolidators who extract non-GAAP metrics from financial reports and present them without adjustment for differing definitions.

Keeping current

Several investors were uncomfortable with their level of understanding of accounting standards. While partly addressed through companies' information sessions and disclosures of material new accounting standards, the increasing complexity in financial reporting may indicate a need for investors to place additional emphasis on financial reporting in their professional development plans.

Areas for improvement

Investors identified various additional areas where reporting should be improved, including segments, pension solvency, and debt covenants. These are set out in **Section 6** of the *Detailed findings*.

Approach

To reach the aforementioned conclusions, a cross-disciplinary team from the Canadian Institute of Chartered Accountants (now CPA Canada), PwC, and Veritas Investment Research conducted one-on-one interviews with over 30 professional investors – chief investment officers, portfolio managers, and buy- and sell-side analysts. We asked interviewees:

- their experiences with the transition to IFRSs;
- how they use financial reports;
- the information they use in decision making;
- their views on non-GAAP measures; and
- areas of reporting that should be improved.

The following pages set out detailed findings and excerpts from the interviews, along with an analysis of the trends.

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Detailed findings

1 Transition to IFRSs

In order to gauge investors' experience with the transition from previous Canadian GAAP to International Financial Reporting Standards (IFRSs), we asked respondents to describe their feelings about IFRSs, specifically their views on the transition's impact on corporate results and disclosure, management's communication of that impact, and whether IFRSs improved investors' understanding of overall corporate performance.

It's a definite positive to have the fair value available there.

In some cases I think it's just a matter of getting up a new learning curve in terms of understanding it.

It's more complex to me because it's new.

Many investors had concerns about the move to IFRSs prior to the transition, but as the transition progressed, investors became more comfortable with IFRSs.

I was looking forward to the adoption of consistent standards around the world... I thought it was a good step forward.

I would say that we were quite apprehensive beforehand. Once we got into [it] we found that [for] a lot of the companies-- it wasn't that big a deal.

I was uncomfortable before it happened... I didn't know exactly what was going to happen so I was uncomfortable… Well now that it's done I've seen the numbers… so now I'd like to say I'm comfortable, with the caveat that maybe there's added complexity that I don't know is there.

Investors reported that companies had generally communicated the material impact of various changes brought on by IFRS prior to the transition, so surprises were reduced to a minimum.

The companies I follow were doing a great job in terms of guidance.

Respondents suggest that IFRSs are generally not considered to be more complex than Canadian GAAP. When asked whether they thought the IFRS transition significantly changed companies' financial results, those who reported significant changes slightly outnumbered those who noticed only minor change. This difference of opinion likely reflects the varying impact of the transition on different industry sectors. The majority of investors who did notice a change in financial disclosures under IFRSs reported no significant improvement in their understanding of companies' performance. The investors surveyed also hold opposing views as to whether the additional disclosures under IFRSs are useful.

More disclosure, but I think it's not complicated.

The obvious areas [of change] would be REITs and financial companies – moving towards more market value accounting. It makes a lot of prior historical comparisons invalid so you don't have a context anymore.

Some of the assumptions have been useful, although I find a lot of companies have already outlined them.

The amount of information that comes at us now is far too much to make a proper decision.

2 How investors use financial reporting

We asked investors to tell us which elements of formal financial reporting they use on a regular basis and the importance of these documents to their investment decisions.

All the investors we interviewed use financial reports on a regular basis, in a number of different ways, and emphasize that almost all aspects of financial reporting are important to their decision making.

Investors rely on formal financial reports, such as the MD&A, financial statements and associated notes, as the basis for building and updating valuation models on the companies they follow and to assist in the ultimate investment decision. More than half of the surveyed investors also indicate that they use financial reports to double-check or supplement other sources of information as part of the investment decision making process.

When I pick up a financial statement the first place I go: cash flow, balance sheet, income statement… the financials are like a map.

I use it to establish historical trends in profitability, cash flow, debt equity ratios, financial strengths and so on.

Usually you start with reading the MD&A, the financial statements and the press release and then you look at that within the context of what's happening out there in the world as relevant to whatever this industry is. From there you talk to the companies on the conference call and clarify things that are not necessarily well articulated.

It's the source documents, the things these guys file. They're really the only things that matter in the model.

Our process doesn't use predictive models extensively. Our process looks a lot at what's happened in the past. We use a lot of historical information.

[Financial statements] are very important – but I would say the notes that go along with them are equally important for making companies comparable to each other.

Several investors also remarked on the usefulness of the Annual Information Form (AIF) as a good tool for understanding the company or business.

Annual Information Form for business risks – I'm not always looking for [the] upside – I'm looking for the potential blow up or downside scenario.

The AIF is a good document because it provides a history that is quite useful and more detailed. The explanation of the industry… and linking all of that together is important.

Investors believe that a clean audit opinion is a prerequisite to investing, but they do not gain additional comfort or insight from the content of the standardized auditor's report.

Well it's important if it's not there. It's important like air and water is important… you'll notice if it's missing.

While a minority of investors use quarterly reporting in the same way as annual reporting, the majority of investors use annual reporting as the primary source of detailed and complete information, supplemented with quarterly disclosures.

We find the full year's results more fulsome – more detail and aligns more with our investment process, which is more of a long-term time horizon.

So we spend less time trying to predict quarters and more time trying to predict 2-3 years out.

We don't use annual reporting, we use quarterly reporting. By the time it comes out… March 31 is Q1.

Most of the investors we surveyed stated they would find it useful to have the Canadian annual report presented as one single document, similar to the 10-K report found in the United States. Reasons for this include the ease of finding information and a reduction in repetition of the same information over several documents. However, a number of investors pointed out that they would rather not jeopardize the timeliness of the releases for the aggregation of a single report.

I think that would be quite helpful as opposed to searching around looking for it all.

More streamlined [reporting] would be better.

3 Evaluation of financial information used in decision making

When asked which three metrics or line items they monitor, investors identified the following most often:

- EBITDA
- Free Cash Flow
- Operating Cash Flow
- Operating Margin
- Revenue
- Gross Margin

Other significant ratios that investors monitor include cash flow-to-debt, debt coverage ratios, return on equity, and return on assets.

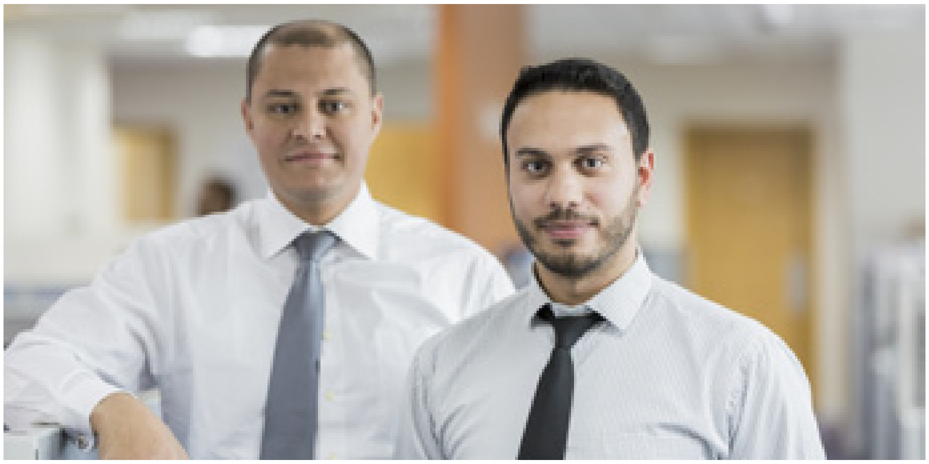
Financial statements are investors' primary source of financial information, though many also use other aspects of financial reporting, such as the MD&A. Some also cited data consolidators as a source of financial information, particularly for non-GAAP measures.

The Income Statement, Balance Sheet, and Cash Flow Statement are all considered very important to investors' decision making. In contrast, Other Comprehensive Income (OCI) is not considered useful and investors placed little value on it, likely because it is not widely understood. In terms of specific disclosures, almost all investors consider segmented information and debt retirement schedules to be very useful to the decision making process. Most investors also agree that the disclosure of assumptions used by management in significant estimates is very useful to decision making.

The financial statements are obviously important because they allow you to do the (quants), but the colour, which is almost equally important, comes from the footnotes and the MD&A.

I may be one of the very few people who actually look at the OCI and I find it extremely useful. But I think it's like the greatest story never told type of thing…

The MD&A is useful because sometimes there is data there that is not in the financial statements, and that might give segment information that's not in the financial statements.



When asked whether the information in the financial statements is sufficient for their needs, most agree that the debt retirement data, cash flow statement, and balance sheet are adequately communicated. However, only half of investors believe that the notes to the financial statements (as a whole) are adequate for their needs, and only a third of investors agree or strongly agree that segmented information and the income statement are sufficiently descriptive.

One problem we have with segmented information is the lack of consistency. Everybody breaks out their segmented information differently.

If it (segment reporting) was all standardized, that would be really, really, helpful.

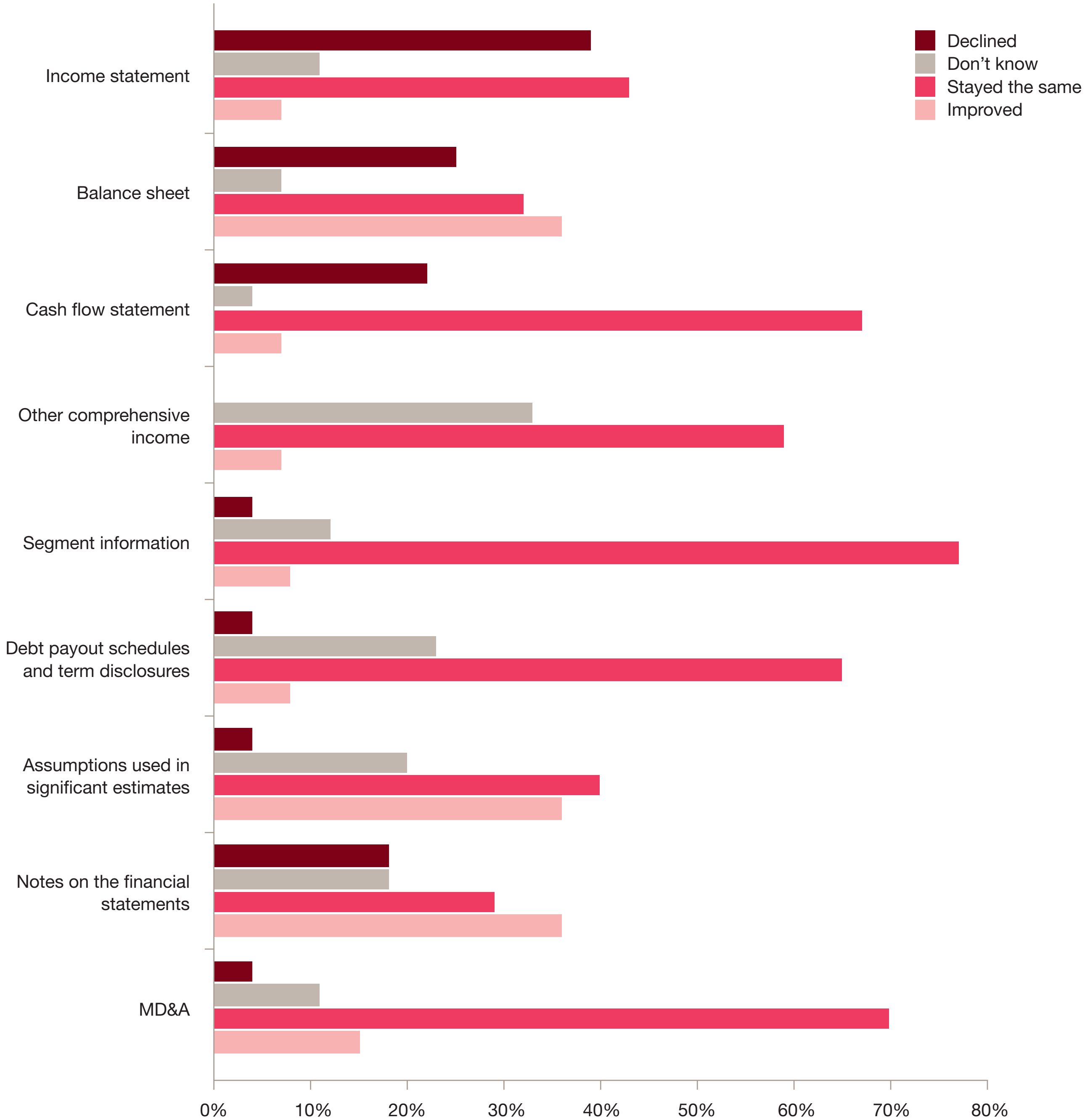
Sometimes things are not standardized, or expenses are not broken out into different line items. Often the costs of sales incorporate 10 different things, so I feel there's a lot of room for improvement.

Some companies are close. But then you can have two companies in the same industry, when one has vastly superior disclosure than the other, and that kind of negates the insights… Is this ratio good relative to someone else in that industry if you can't find someone to compare it to?

One of the problems with the MD&A is that it's progressively getting less useful because it's more focused on litigation risk.

The MD&A is probably the biggest thing for me. I can't tell you the number of times the characterization of a set of results in the press release would differ, sometimes materially, as you dig into the MD&A.

We also asked investors whether various aspects of financial reporting had improved, deteriorated or remained equally useful in the transition to IFRSs. The following table illustrates our findings:



4 Evaluation of non-financial information used in decision making

Investors use a number of sources for other information not generally found in the financial statements:

Non-Financial Information	Most Cited Sources*					
	Meetingts with Management	MD&A	Annual Information Form	Financial Statements	Management Information Circular	Sell-side Research
Strategy	✓	✓	✓			
Competitive environment	✓					
Risk disclosures		✓	✓	✓		
Information about management (including compensation)					✓	
Industry-specific metrics & other KPIs						✓
Environmental and social impact		✓	✓			
Governance information			✓		✓	

* Cited by 15% or more of our respondents

Survey participants noted that information on strategy and the competitive environment are the most important of these categories. Most investors believe that they receive adequate information about a company's strategy, although only half are satisfied with the information on the competitive environment.

Meetings with management are nice to have, but I really rely on source documents.

I have to do so much incremental work outside of the scope of the financial statements. Most of my time is spent doing my own competitive analysis, talking to customers, talking to vendors, global trends...

The quality of the information really depends on the company.

Information on strategy – it's helpful, but the adequacy could be better. Some companies are great, for others – it's a head scratcher.

There's very little information on the competitive environment.

I don't think companies need to give me more information about their competitive environment. That's our job.

For many investors, risk disclosures, industry-specific metrics, governance information and information about management are also important to their decision-making. Of these disclosures, investors generally believe that both risk disclosures and governance information could be greatly improved. Investors suggested that risk disclosures could be more entity-specific and ranked in order of probability, while several respondents categorized governance disclosures as seemingly a "check the box" exercise, rather than a communication of the underlying ethics and culture of a company.

They'll state the issue but won't go into how likely it is… the probability of it occurring.

There are forty risk statements, most of which may not even be relevant.

I would rather just have the top three risks that are facing your business today.

I do look to see who is on the Board. I know most of the guys. I'll know if they're independent or not from experience.

I'm not sure you're ever going to get a good self-assessment when it comes to governance.

We also asked investors how useful they found social impact and environmental information. More than half of investors agree that this is not useful information for their decision making. At the same time, there are mixed views on the adequacy of current disclosures. Some investors believe there is plenty of information on these topics, but that it is not useful, while others viewed environmental and social impact information as very useful, but found the current disclosures inadequate for their needs. Responses suggest that if more meaningful information about social and environmental factors were to be communicated consistently by all companies, investors would place greater emphasis on such factors when assessing a company.

These disclosures are relatively new. Everybody is learning and trying to find out what assists investors and regulators... it's still a work in progress.

A lot of companies have environmental reports and I think that's important, but I don't think it's critical.

Some companies put out an entirely separate report. I can't say that I have actually read one.

I don't think anyone has figured out yet what to actually measure. So is it adequate? Probably not.

Internally, we're trying to push on the ESG thing. It's useful info – just done in a really bad way.

5 Non-GAAP measures

More than half of the investors we surveyed perceived an increase in the use of non-GAAP measures since the adoption of IFRSs. Overall, investors are positive about the perceived increase in non-GAAP measures, with approximately 80% of respondents finding the measures useful.

My perception is that it's more common – not sure if that's IFRS or a general trend.

Some of those metrics are much more economic reality...much more the underlying business.

They provide more granularity than the GAAP measures.

In the oil and gas industry it's where they marry volumes with financial results... it's critical for understanding the business.

IFRS doesn't have a whole lot of say in a reserve evaluation, for example – oil, gas, mining companies... I pay a lot of attention to that.

Survey responses clearly indicate that investors believe non-GAAP measures provide valuable additional information. However, investors are divided on what management's motivations are for using non-GAAP measures. Some believe non-GAAP measures give management a chance to show underlying operating and financial performance, while others believe management provides the measures to show a better picture of performance than would otherwise be permitted by GAAP. A few investors have a foot in both camps, stating that their view depends on the level of trust they have in a company's management.

It depends on if you trust management or not.

One answer could be to make themselves look better. For others it's to make themselves more comparable.

It's window dressing – no question about that.

We need GAAP but it's not the only way to look at a company. These additional measures provide insight into the underlying performance of a business.

This is our earnings before inconvenient items.

Despite skepticism about management's motivations in disclosing non-GAAP measures, most investors are not concerned that non-GAAP measures are outside the scope of the financial statements and thus are not audited. However, many investors believe that there should be some assurance around compliance with regulatory guidance over non-GAAP financial measures.

As long as non-GAAP measures are shown somewhere I don't care where they are shown.

I want the auditors to do some procedure on this so that there is comparability, consistency and so on because it's being disclosed and it's being relied upon.

I think it [assurance] would be useful, at the right price.

Overall, investors seem to be content with the current rules regarding the presentation, calculation and disclosures of non-GAAP measures. In particular, investors value the requirement that a non-GAAP measure must be defined, and that changes in its composition from year to year must be highlighted and explained. Investors are most concerned with consistency, and believe that it would be preferable to restate a prior year's non-GAAP measure when its composition changes, rather than only describing the change.

It would be very helpful… either go back and change what you presented before or really question whether you should be changing your methodology at all.

Even if it's non-GAAP there should be comparability over periods. You want the trend.

We also asked whether non-GAAP measures should be presented only if they are used by management in running and assessing the business, but most investors disagree with this restriction. Investors believe that providing commonly used non-GAAP measures, such as EBITDA or measures common across particular industries, is useful even if management does not use the measure internally.

If they don't use it internally but the outside world uses it, it's important.

6 Areas for improvement in financial reporting

Finally, we asked investors for their wish list – what three things would they most like management or standard-setters to improve about corporate reporting. The most common responses (in order of frequency of occurrence) given by respondents as areas for improvement are:

1. **Consistency, disclosure of calculations and appropriateness of non-GAAP measures**
2. **Improved segmented information and/or increased disaggregation of information to enhance users' understanding of the underlying operations**
3. **Reduction in the volume of notes, but increased relevance and readability of items disclosed within financial statements**
4. **Disclosure of pension solvency calculations**
5. **An enhanced MD&A, which provides a variance analysis between management's planned actions and actual results and eliminates boilerplate disclosures**
6. **Better disclosures of significant assumptions used in financial statement preparation would allow investors to re-perform calculations**
7. **Disclosure that distinguishes maintenance capital expenditures from growth capital expenditures**
8. **More meaningful risk disclosures**
9. **Increased disclosures surrounding the constitution and calculation of debt covenants**
10. **Increased consistency of accounting policies between companies in similar industries**

What investors said about...

Non-GAAP measures

There should be some accountability when there's a departure from industry standards in terms of non-GAAP measures.

I would like to see more standards around how they are calculating the numbers.

I would like to see non-GAAP measures provided on a segmented basis.

Disaggregation of information

Segmentation really shows what goes on below the surface.

We need more disaggregation in the numbers... companies aggregate so they can mask mistakes.

I'd like to see more segmentation of the revenue line than I generally get.

Disclosure overload

Reduce the volume of information. When you ask people if they want more disclosure they always say yes, but it becomes too much. There's very little added value.

Get rid of the boiler plate – give me some meaningful disclosure.