# PRACE NAUKOWE
Uniwersytetu Ekonomicznego we Wrocławiu

# RESEARCH PAPERS
of Wrocław University of Economics

Nr 375


## Quantitative Methods in Accounting and Finance

edited by
Edward Nowak
Ruslan Motoryn
Marcin Wierzbiński


Publishing House of Wrocław University of Economics
Wrocław 2015

Copy-editing: Elżbieta i Tim Macauley

Layout: Barbara Łopusiewicz

Proof-reading: Barbara Cibis

Typesetting: Agata Wiszniowska

Cover design: Beata Dębska

This publication is available at www.ibuk.pl, www.ebscohost.com,
Lower Silesian Digital Library www.dbc.wroc.pl,
and in The Central and Eastern European Online Library www.ceeol.com
as well as in the annotated bibliography of economic issues of BazEkon
http://kangur.uek.krakow.pl/bazy_ae/bazekon/nowy/index.php

Information on submitting and reviewing papers is available on
the Publishing House's website
www.wydawnictwo.ue.wroc.pl



**ISSN 1899-3192**
**ISBN 978-83-7695-427-1**

The original version: printed

Printing: EXPOL, P. Rybiński, J. Dąbek, sp.j.
ul. Brzeska 4, 87-800 Włocławek

## Table of contents

## Streszczenia

PRACE NAUKOWE UNIWERSYTETU EKONOMICZNEGO WE WROCŁAWIU
RESEARCH PAPERS OF WROCŁAW UNIVERSITY OF ECONOMICS nr 375 • 2015

Quantitative Methods in Accounting and Finance ISSN 1899-3192

**Edward Nowak**
Wrocław University of Economics
e-mail: edward.nowak@ue.wroc.pl

# THE USEFULNESS OF INFORMATION DISCLOSED IN COMPANY ANNUAL ACTIVITY REPORTS

**Summary:** The company annual activity report – or management commentary – is an important element of the annual financial report. Its main purpose is to supplement financial data with additional information that may be of use for company stakeholders in their evaluation and decision-making processes. The usefulness of the information disclosed in annual activity reports is closely related to the scope, character, and quality of the content. This paper presents an evaluation of the information capacity associated with this type of reports, from the viewpoint of the company stakeholders' needs and interests, with an emphasis on the qualitative characteristics expected from this type of information, and classified into primary and enhancing characteristics.

**Keywords:** reporting, annual activity report, economic information, information quality, information usefulness

DOI: 10.15611/pn.2015.375.13

## 1. Introduction

Annual reports, the most important form of financial reporting documents required from economic entities, typically include financial reports on company activities, supplemented by commentary information in the form of an annual activity report (also referred to as Practice Statement). Information disclosed in the report is of great value to the various stakeholders, particularly the investors, creditors and lenders. Stakeholders expect this information to be useful in the context of the evaluation and decision-making processes made with respect to the company that discloses them. Financial information, in the form of statements presenting historical values of financial data, is considered insufficient, particularly for evaluating the entity's development prospects and potential risks. Therefore, stakeholders show increased demand for information of an non-financial and prospective character.

In recent years the need for information pertinent to those entity's activities that are not disclosed in standard reporting formats has grown considerably. The annual activity report formula is designed to address this need, and modern organizations are increasingly more aware of the potential benefits offered by this type of reporting. The growing importance of practice statements for company stakeholders is closely related to the increased volatility of the economic environment, and the growing complexity of the evaluation tasks involved. However it is essential that the information included in annual activity reports is useful for all stakeholders.

This paper focuses on the analysis of the qualitative features offered by the information disclosed in annual activity reports, i.e. those qualities that improve the quality and usefulness of non-financial information passed on to company stakeholders. The central thesis of this study can be expressed as follows: the usefulness of the information disclosed in company reports is related not only to the content of the report, but also to the quality of the information presented therein. For this purpose, standard approaches to the task of evaluating the informative quality of economic information included in company reports are analyzed, as recommended in the accounting and financial reporting regulations, and supplemented with a critical evaluation of the solutions postulated in the professional literature.

## 2. The purpose and the information capacity of annual activity reports

The annual activity report, also referred to as the practice statement management commentary, has become an important and valuable addition to the company annual financial report. This trend is based on the observation that financial statements, formerly regarded as the most essential part of the report, are no longer adequate and sufficient in the context of the increased information needs of various stakeholder groups. Nowadays, company stakeholders expect more than the basic historical overviews of financial records. Management commentaries not only offer an increased range and usefulness of the information disclosed in annual reports, but also meet the definition of 'other financial reporting' to supplement the financial statement. The increased significance of this instrument has been reflected in the pertinent regulations and recommendations of various organizations, both domestic and international.

In 2010, the International Accounting Standards Board (IASB) published an *"IFRS Practice Statement Management Commentary. A Framework for Presentation"* [IFRS…, 2010]. The document clearly states that the IFRS Practice Statement is not an IFRS as such, but merely 'a broad, non-binding framework' of theoretical assumptions and recommended practices designed to improve the usefulness of financial statements prepared in accordance with the International Financial Reporting Standards. This practical approach presents the recommended principles, qualitative features and management commentary that are necessary to provide stakeholders with useful information [Nowak 2012].

According to the practical approach presented by the IASB, the management commentary should follow the format of a narrative report, and provide a broader context for the interpretation of the information disclosed in the financial statement. Based on the information provided in the management commentary, stakeholders should be able to accurately interpret the entity's financial position, asset structure, financial results and cash flows. It should also enable them to perform accurate evaluations of the entity's prospects, its performance against the stated objectives, as well as any associated risks [Kabalski 2011].

In the European Union, the content of annual activity reports is regulated in the new Directive of the European Parliament and of the Council (2013/34/EU) on the annual financial statements and related reports. According to Art. 19 of the Directive, the management report should provide a fair review of the development of the business and of its position, together with a description of the principal risks that may apply. The review should take the form of a comprehensive and balanced analysis of the above, in a manner consistent with the size and complexity of the business. This analysis may be supplemented and complemented by both financial and non-financial key performance indicators, by segment of operation, particularly with respect to environmental and employee matters.

In the light of the Directive's recommendations, the management report should also provide information on the following:

– the anticipated course of business development,
– the adopted R&D activities,
– the subsidiaries (if any),
– the use of financial instruments,
– the adopted business objectives and risk management strategies,
– the undertaking's exposure to price risk, credit risk, liquidity risk and cash flow risk.

Public-interest entities should also include a corporate governance statement in their management reports.

In Polish legislature, the content of annual activity reports is regulated by the Accounting Act (art. 49 pos. 1). The annual report should provide material information on the asset structure and financial position of the entity, including a performance assessment and a description of identified risks and threats. The scope of the information disclosed in accordance with the recommendations of the Act is similar to that of the 2013/34/UE Directive.

In 2013, the Committee for Accounting Standards (KSR), affiliated with the Polish Ministry of Finance, published a draft of a National Accounting Standard for Activity Reports, designed to assist economic entities in providing meaningful information to their stakeholders, and to propagate best reporting practices. The draft of the standard does not provide any unified form of reporting. Instead, a list of guidelines is provided, specifying the recommended content, structure, features, and principles for the preparation and presentation of the relevant information in this respect [*Sprawozdanie*... 2013].

According to the KSR draft, the annual activity report should include the following [*Sprawozdanie*... 2013]:

1) a description of activities,
2) the undertaking's objectives and strategy,
3) resources, relations with stakeholders, and risks,
4) key performance indicators, financial position, and prospects for development,
5) information on the adopted corporate governance code.

The KSR approach is, to a large extent, convergent with the recommendations set out by the International Accounting Standards Board.

All the above accounting and reporting regulations adopt a similar approach to the informational content of activity reports. A comparative analysis of the content provided in these regulation suggests that the most important information to be included in management commentaries is the report of the entity's potential for development. This particular requirement is based on the assumed continuity of operation in the foreseeable future. This assumption is important to the stakeholders, since the entity's potential for development is one of the fundamental factors which influence their decisions.

## 3. Usefulness as the overriding qualitative feature of the information disclosed in annual reports

The recommendations provided by the International Accounting Standards Board (IASB) in *Management Commentary. A Framework for Presentation* specify some of the distinct qualitative features to be observed with respect to the financial information disclosed in the reports. These features directly relate to the information presented in the obligatory financial statements. At the same time, it must be noted that the notion of 'the quality of financial information' is not provided for as such. Neither the *Management Commentary* nor any other regulative document on financial reporting provides a definition of such a notion. Instead, the normative acts specify the most important qualitative features of the information disclosed in financial statements.

The practical recommendations of the IASB regarding management commentaries fail to provide any specific features to be included in such documents. However, the IASB text clearly states that the management commentary should be considered on a par with other elements of the financial reporting, and that it should be read in the context of the *Conceptual Framework for Financial Reporting*. The economic information presented in a management commentary should, therefore, fulfill the qualitative requirements laid down in the *Conceptual Framework*.

For the purpose of this study, let us attempt to define the notion of 'quality' with respect to the information presented in annual reports. In this sense, the qualitative aspect of the information presented in the reports may refer to those properties that make the information more useful for the recipient. Thus, it may be assumed that the higher the quality of information used by the recipients, the more accurate they are in their evaluations and decisions made based on the provided content. In effect, the quality of information presented in obligatory reports decides about its practical usefulness for particular stakeholders of a given economic entity.

The above definition suggests that, for company stakeholders, the usefulness of the economic information presented in activity reports should be regarded as the primary qualitative feature. Usefulness of information, in this context, refers to its capacity to satisfy the needs communicated by the user [Bujak 2011]. This primary property of financial information is defined in the *Conceptual Framework* by means of two 'fundamental' qualitative features: relevance and faithful representation.

Relevant financial information is capable of making a difference in the economic decisions made by users [*International*... 2011, p. A36]. For stakeholders, this property is of fundamental value, since they employ the information presented in activity reports in all their decisions made with reference to the entity. Economic information is relevant for the user if it provides alternative variants of action and enables the user to make an informed choice of the most optimal nature, under the given circumstances.

Under the provisions of the *Conceptual Framework,* the relevance of the economic information is further expanded to provide two distinct values [*International*... 2011, p. A37]:

- the prognostic value, referring to its use for making informed forecasts of future results,
- the confirmatory value, referring to its capacity to inform on past evaluations, resulting in the confirmation or modification of previous knowledge.

The relevance of the economic information decides about its usefulness for the stakeholders of a given economic entity. Since some of the measures presented in the reports are based on estimations, their usefulness is also strongly related to the faithful representation of the phenomena they purport to represent. In the light of the *Conceptual Framework*, a faithful representation of the phenomena is defined in terms of three distinct qualities: completeness, neutrality and freedom from errors [*International*... 2011, pp. A37-A38].

Furthermore, the *Conceptual Framework* provides a set of qualitative characteristics that enhance the usefulness of the information presented in financial reports. These enhancing qualitative characteristics include:

- comparability, enabling users to identify and understand similarities in, and differences among the items presented in reports,
- verifiability, helping to assure users that the information represents faithfully the economic phenomena it purports to represent,
- timeliness, meaning that the information is available to decision-makers in time to be capable of influencing their decisions,
- understandability, representing the postulate for classifying, characterizing and presenting information in a clear and concise manner.

All the above qualitative characteristics of information are, in the text of the *Conceptual Framework*, related directly to financial reports, but they also apply to the financial information provided ‘in other ways’, e.g. in the form of annual management commentaries (activity reports). With regard to the latter, the information disclosed therein should also possess other qualities – which are presented in the next section.

## 4. Other complementary qualities of the information presented in annual activity reports

The information presented in annual activity reports is complementary and supplementary to the content disclosed in financial reports. Its purpose is to present the user with historical explanations of the amounts presented in financial statements, as well as descriptions of the determinants that influence the values of various financial categories: assets, capital, income, cost, and financial results. Company management should strive to avoid redundancy in reporting, by excluding from the activity report the details provided elsewhere, e.g. in the form of the explanatory notes attached to the financial statement. It must be stressed that the repetition of information in various elements of the entity’s annual report will not improve its usefulness for the stakeholders. On the contrary, redundant information may, in fact, obscure the true image of the entity, and make it difficult for users to properly interpret and understand those issues that are most fundamental for the evaluation of the entity’s prospects [*International*... 2011, pp. B1934-B1936].

Another desirable quality of the information presented in annual activity reports is consistency. First of all, the information should be consistent with its related elements of the financial report. If the financial statements include segment information, the information presented in the management commentary should reflect that segmentation. This is meant to ensure that the annual activity report, as a whole, is as coherent as possible.

The consistency in presenting the information in activity reports also applies to the character of the disclosed content. In this context, the information should be consistent on the following planes:
– financial and non-financial,
– historical vs. planning and forecasting information,
– internal vs. external,
– by period of presentation,
– by cross-sections,
– between various forms and reports,
– by distinct categories and types of economic events.

The relevance postulate also applies to the information presented in activity reports. It refers equally to those parts of the report which are important from the viewpoint of the entity’s objectives, and those that may influence the decisions made by the entity’s stakeholders. Its relevance should be regarded as one of the most important aspects of the information’s usefulness: if the information is useful, it is also considered relevant. It must be noted, however, that the relevance of the information should be analyzed solely in respect of the entity it describes.

Activity reports should exclude information considered too specific, that is usable for the entity's management, rather than the entity's stakeholders. This is meant to ensure that the user is not overburdened with irrelevant information which may obscure the true image of the entity's prospects. An excess of information may often prove more dangerous than an information deficit, since it may obstruct the proper identification of the most important issues. Moreover, the supply of information in excess of the needs communicated by users may result in extra costs for the entity [Nowak 2010].

The US Financial Accounting Standards Board (FASB), in their *Statement of Financial Accounting Concepts* (SFAC) postulated a set of qualitative properties of information to be met in order to make it useful for the stakeholders. Among the so-called decision-oriented characteristics, the SFAC 2 ("*Qualitative Characteristics of Accounting Information*"), places the emphasis on relevance as one of the primary qualities. Information is considered relevant if it relates to the problem at hand [SFAC No 2, 1980].

The *International Good Practice Guidance. Evaluating and Improving Governance in Organizations*, published by the International Federation of Accountants, postulates the need to balance the two dimensions of governance, namely performance and conformance. The conformance dimension, in general, tends to take a historic view, while the performance dimension is more forward-looking. Performance and conformance dimensions supplement and complement each other, and enhance the organization as a whole – not only the entity itself, but also its stakeholders [*International*... 2009]. This conclusion also applies to the information presented in the annual report, with the activity report considered an important element thereof.

The disclosure of information in the form of a management commentary (or annual activity report), as opposed to information presented obligatorily in financial statements, is non-binding, and no officially recognized standards and legislative regulations apply here. The approach presented in the IASB Practice Statement is not an International Financial Reporting Standard. The Polish KRS draft of the National Accounting Standard for Activity Reports adopts a similar legal stance. The respective regulations contained in the Polish Accounting Act are also quite general with respect to the content of annual activity reports. Consequently, the range of information and the form of presentation are largely at the discretion of the entity's management [Kwiecień... 2007]. In effect, the management is free to pursue their own information policy, for example – by placing the emphasis on information considered useful for the entity and its objectives, while playing down other issues that may be of more use to their stakeholders.

Therefore it is important to ensure that the presentation of information in annual activity reports be free of any superfluous marketing. The report should be prepared with due diligence and in a balanced form, to reflect the true value of both the positive and negative outcomes. It is not advisable to obscure the negative information. One should place full emphasis on the impartiality of the information presented in annual activity reports, in order to render an accurate image of the entity's present situation and future prospects.

## 5. Conclusions

Annual activity reports, otherwise referred to as management commentaries, may be an important source of information for the stakeholders, and employed to good effect in their evaluation and decision-making processes. For that to take place, the information disclosed in the reports should comply with a set of specific qualitative properties, with usefulness for stakeholders regarded as the primary postulate. Usefulness is a compound attribute of the economic information presented in annual reports, comprising of primary and enhancing characteristics, as defined in the *Conceptual Framework for Financial Reporting*. The annual activity report, due to its character, should also conform with certain other qualitative characteristics that make it more useful for the stakeholders of the economic entity. An important limitation in this context is the need to maintain a proper balance between the potential benefits and the cost involved, so that the preparation, presentation and use of annual activity reports be as economically rational as possible.

## References

Bujak A., 2011, *Jakość i jej pomiar w odniesieniu do systemu informacyjnego rachunkowości*, Prace Naukowe Uniwersytetu Ekonomicznego we Wrocławiu, no. 210.

*IFRS Practice Statement Management Commentary. A Framework for Presentation*, 2010, IASB, London.

*International Financial Reporting Standards (IFRSs)*, 2011, International Accounting Standards Board. IFRS Foundation, London.

*International Good Practice Guidance. Evaluating and Improving Governance in Organizations*, 2009, International Federation of Accountants, New York, July.

Kabalski P., 2011, *Komentarz zarządu IASB w współczesne paradygmaty zarządzania przedsiębiorstwem*, Zeszyty Teoretyczne Rachunkowości, no. 61 (117).

Kwiecień M., 2007, *Czym jest sprawozdanie z działalności w roku obrotowym*, Prace Naukowe Akademii Ekonomicznej, no. 1199.

Nowak E., 2010, *Wpływ norm rachunkowości na jakość informacji zarządczej*, Prace Naukowe Uniwersytetu Ekonomicznego we Wrocławiu, no. 122.

Nowak E., 2012, *Sprawozdanie z działalności jako źródło informacji o dokonaniach przedsiębiorstwa*, [in:] Nowak E. (ed.), *Pomiar i raportowanie dokonań przedsiębiorstwa*, CeDeWu, Warszawa.

SFAC No 2, 1980, *Qualitative Characteristics of Accounting Information*, FASB, New York, May.

*Sprawozdanie z działalności. Projekt Krajowego Standardu Rachunkowości*, 2013, [in:] *Zamknięcie Roku 2013*, Rachunkowość, Special Issue, Warszawa.

The Directive of the European Parliament and of the Council 2013/34/EU of June 26 2013, Off.J. EU L 182/19 of 29.06.2013.

## UŻYTECZNOŚĆ INFORMACJI UJAWNIANYCH W SPRAWOZDANIU Z DZIAŁALNOŚCI JEDNOSTKI

**Streszczenie:** sprawozdanie z działalności jest ważnym elementem rocznego raportu, uzupełniającym sprawozdanie finansowe. Jest ono źródłem informacji istotnych dla interesariuszy, przydatnych przy dokonywaniu ocen i podejmowaniu decyzji. Użyteczność informacji ujawnianych w sprawozdaniu z działalności zależy od ich zakresu, charakteru i jakości. W artykule dokonano oceny pojemności informacyjnej tego sprawozdania z punktu widzenia potrzeb interesariuszy jednostki. Szczególną uwagę zwrócono na cechy jakościowe, jakimi powinny odznaczać się informacje prezentowane w sprawozdaniu z działalności jednostki, wyróżniając cechy nadrzędne i dodatkowe.

**Słowa kluczowe:** sprawozdawczość, sprawozdanie z działalności, informacje ekonomiczne, jakość informacji, użyteczność informacji.