New Developments in Management Reporting – The Modernisation of the Annual Report

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A. Introduction

In Germany, the management report that comments on the company's business and financial position as well as its future prospects has long ago been introduced to the *Handelsgesetzbuch* (*HGB* - German Commercial Law). Ever since the European Court of Justice [ECJ] has clarified that *GmbH & Co. KGs*[1] are classified as companies with limited liabilities under the 4th and 7th Directive, annual reports have to be published by an even wider range of companies.[2]

Requirements for the annual report are set out in various legal instruments adopted by the EU, in particular the 4th and 7th Company Law Directives ("Accounting Directives"), which have recently been updated by the Modernisation Directive.[3] The Directives demand an annual report about the development and performance of the business and the position of the undertakings for corporate companies as well as banks and other financial institutions irrespective of admittance to regulated securities markets.[4]

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[1] *GmbH & Co. KG* is a limited partnership where all of the fully liable members are constituted ad private limited liability companies.

[2] The German terminology usually refers only to *Lageberichterstattung*, whereas there are several English translations. European Accounting Directives differentiate between annual reports and consolidated annual reports. Within National Laws and German Accounting Standards the term is translated into Management Report. Internationally still other terms with similar meanings have emerged. This includes Management Discussion and Analysis (MD&A) or Management Commentary.

[3] See Directive 2003/52/EC of 18 June 2003 (Modernisation Directive).

[4] Article 46 (1) and (2) of the Fourth Council Directive (78/660/EEC) and Article 36 (2) of the Seventh Council Directive (83/349/EEC), last amended by Directive 2003/51/EC, OJ No. L 178, 17.7.2003, p. 16.

In the absence of international standards for management reporting or similar reporting instruments the European Directives will remain effective accordingly for (consolidated) annual reporting within IFRS-reports.

B. *BilReG* – Reform Act on Accounting Regulations

The Modernisation Directive was transformed into national law by the *Bilanzrechtsreformgesetz (BilReG* - Reform Act on Accounting Regulations)[5]. Following the Directive these amendments to the *HGB* are intended to improve the quality of annual reporting as well as the consistency and comparability of these reports.[6] Hence, to the extent necessary for an understanding of the development, performance or position of the business, the analysis shall include both financial and non-financial key performance indicators. By including non-financial indicators the *BilReG* aims to take ecological and social aspects such as environmental or employee matters into account. Furthermore the *BilReG* sets out detailed requirements on disclosures about risks arising from financial instruments within the management report. The enhancements of § 289 HGB (management report) and § 315 HGB (consolidated management report) do not only result from the Modernisation Directive. Exceeding this Directive the *BilReG* also demands reporting about chances of future developments in addition to risk reporting to enhance the quality of the management report and to allow for target-performance-comparisons.[7]

In the explanatory statement for the *BilReG* the legislature explicitly refers to accounting standards developed by the German Accounting Standard Board (GASB). These standards facilitate the harmonization of consolidated management reports. Against this background the *Bundesministerium der Justiz* (*BMJ* - Ministry of Justice) published the German Accounting Standard (GAS) No. 15 *Management Reporting* on 26 February 2005, which specifies the Reform Act taking international developments into account. It also provides recommendations going beyond the legal requirements. Thus the management report clearly becomes a more vital element of a value and future oriented financial reporting system. Its intention is to improve the users' ability to derive an accurate picture of the development and position of the business as well as significant opportunities and risks likely to determine the future operations of an entity.

[5] *The* German *Bilanzrechtsreformgesetz* was enacted on 4 December 2004.

[6] See Modernisation Directive, Reasoning (9) and explanatory statement for *BilReG*, 23 – 24.

[7] See BMJ, explanatory statement for *BilReG*, 24.

C. German Accounting Standard GAS 15

The Standard sets out to establish five principles for the annual report. Following these principles an annual report needs to be complete, reliable, clear and transparent. Furthermore the report should display the management's perspective in the manner of the management approach and has to focus on sustainable value creation. Subsequently GAS 15 is composed in accordance with the structure recommended for an annual report. A consistent structure throughout management reports nationwide will enhance their comparability and the ability to find selected information. GAS 15 recommends structuring the annual report as follows: business and operating environment, results of operations, financial position and net assets, report on post-balance sheet date events, risk report and report on expected developments. Since the management report is part of the legal requirements and subject to auditing it has to be clearly separated from additional information, which is for instance published by listed companies within their management reports.

The starting point for reporting is an overview of the group, its business activities and the operating environment. This includes addressing research and development activities. Complementary management is required to present and assess the development of the business throughout the reporting period. In addition capital market orientated enterprises are required to describe and discuss their internal control system. This includes information about key performance indicators that are internally used to manage the company.[8] This could be traditional indicators like turnover or value oriented indicators such as return on net assets (RONA) or economic value added (EVA). The quantification of the key performance indicators is recommended.

I. Analysis on the basis of financial and non-financial key performance indicators

The *BilReG* explicitly requires an analysis of the development of the business and of its position, in a manner consistent with the size and complexity of the business operations. This analysis shall include the particular financial and non-financial key performance indicators. In the analysis the companies have to comment on references to data in the annual accounts and the notes. Especially preparers of IFRS-statements will be able to take advantage of the possibility to refer to information that is already given in parts of the financial statements. Because numerous information that is required for the management report, e.g. about risks arising from

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[8] GAS 15.38 and 15.94 – 98.

financial instruments, is already disclosed in the notes.[9] References to information disclosed elsewhere will avoid duplication. Still, in total the financial statements are more likely to present figures and facts, whereas the management report mostly analyses and comments on these numbers.

According to legislation financial key performance indicators are performance indicators which are measurable in terms of money units such as performance growth and profit components, liquidity and capital resources. GAS 15 requires information about the development of the business activities during the financial year under review as well as information about the economic position at the preparation date. Events and trends determining the results of business operations have to be discussed, pointing out factors that had or could have a significant effect on the economic position of a company. Furthermore disclosures about off-balance-sheet arrangements such as extensive sale and lease-back transactions might be needed.[10]

European legislation also specifies requirements for disclosing non-financial key performance indicators; as far as they are significant to first the company's business and second to the understanding of the business development and economic position. Under German legislation these disclosures are required only for large companies with limited liability and consolidated groups. Examples for these non-financial key performance indicators are information relating to environmental and employee matters. However, the German legislature clarifies in the basis for conclusion to the *BilReG* that the examples given are neither exhaustive nor an obligation to focus on these aspects.[11] Instead, factors generally not measurable in terms of money units should also be included. Hence aspects such as trend information concerning the customer base or the human capital of the company have to be considered and evaluated more closely. GAS 15 recommends disclosure of intangible items and if possible their quantification.[12] The German Accounting Standard Board (GASB) is of the opinion that intangible items are of immense importance to a company. This is partly due to new business structures and technical developments that emphasize the influence of intangible assets on the overall outcome. It is also due to the need to adapt accounting rules to these new business models and business operations.

[9] See IAS 32.51 – 32.85. See www.iasb.org/current/ed.asp for the recent status of the Exposure Draft *Financial Instruments: Disclosures* (ED 7).

[10] See GAS 15.67 – 68.

[11] See BMJ, explanatory statement for *BilReG*, 25.

[12] See GAS 15.31 – 32 and 15.111 – 119.

II. Opportunities and risks of the expected development

Recent studies[13] about the quality of annual reports of German companies find that the average quality of annual reports is increasing. However, especially annual reports of unlisted companies show considerable deficits. These companies need to substantially improve their future oriented disclosures in order to comply with legal requirements by the *HGB*.

By *BilReG* and GAS 15 the requirements regarding future oriented information are still expanded. Furthermore risk reporting is amended by more detailed disclosure requirements for risks arising from financial instruments. In addition, reports on expected developments hence will have to include chances of the expected development. Significant assumptions underlying forward-looking statements of the management shall also be disclosed. In this context GAS 15 requires at a minimum the disclosure of qualitative information about existing projections and management's expectations for the following two financial years. The disclosure of quantified information is recommended. This could include figures for profit and revenue for the following year.[14]

Reporting about objectives and strategies of a company are key elements in international standards on annual reporting.[15] While requirements concerning objectives and strategies were originally part of the exposure draft of *BilReG*, it was later withdrawn by the legislature when the *Bundestag* (Lower House of German Parliament) objected. The *Bundestag* had reservations that requiring publication of this information might provoke competitive disadvantages. This leads to the question though, how companies are to report about expected developments without referring to their planned and expected contribution to these developments. A trading company for instance will hardly be able to describe what the management expects

[13] See HANS-BÖCKLER-STIFTUNG, Qualität der Lageberichterstattung von Kapitalgesellschaften in Deutschland unter besonderer Berücksichtigung der Darstellung von Risiken der künftigen Entwicklung (2004); Karlheinz Küting and Christian Zwirner, *Ergebnisse einer mehrjährigen empirischen Analyse der Informationsqualität deutscher Geschäftsberichte*, 5 STEUERN UND BILANZEN 193 – 200 (2003); Karlheinz Küting and Matthias Heiden, *Zur Informationsqualität der Lageberichterstattung in deutschen Geschäftsberichten – Branchenangaben, Risikobericht, Prognosebericht*, 19 STEUERN UND BILANZEN 933 – 937 (2002).

[14] See GAS 15.34

[15] See IASB MD&A – RESEARCH GROUP; Research Group Findings as presented at IASB meeting February 2005, Preliminary Views: (f); CANADIAN PERFORMANCE REPORTING BOARD, Management's Discussion and Analysis – Guidance on Preparation and Disclosure (2004), par. 240.1, 310.1 and 320; ACCOUNTING STANDARD BOARD (ASB), Exposure Draft of a Reporting Standard (RED 1) on the Operating and Financial Review (2004), par. 28 – 40.

from future developments without reporting on expansion plans in new markets. This also challenges the legislative purpose to allow for an objective-performance-comparison, since disclosures regarding management's objectives are not part of the reporting requirements.

D. European developments

Despite deficits in the average quality level of annual reports Germany has lead the way internationally. Already in 1998 the *Gesetz zur Kontrolle und Transparenz im Unternehmensbereich* (*KonTraG* - Law on Corporate Control and Transparency) amended the *HGB* requiring companies to provide information about risks in their management reports. These requirements were specified by issuing GAS 5 *Risk Reporting*. Only recently did these requirements become obligatory in all member states of the EU.[16]

Furthermore the European legislature passed the EU Transparency-Directive[17] in December 2004, therewith acknowledging the annual report as an instrument to harmonize capital markets in Europe. Just like the Management's Discussion and Analysis (MD & A) required in the United States of America, the annual report will be a compulsory component in addition to IFRS financial accounts. This applies to all issuers whose securities are admitted to trading on a regulated market, for annual periods beginning on or after 1 January 2007.[18]

It is assumed that efficient, transparent and integrated securities markets contribute to a genuine single European market and that the disclosure of accurate, comprehensive and timely information about security issuers builds sustainable investor confidence and allows an informed assessment of their business performance and assets. This enhances both investor protection and market efficiency. To make the comparison of annual financial reports easier is only of use to investors if this information will be published within a certain time after the end of the financial year. This motivates the EU to noticeable enhance the requirements for regular interim reporting. For all issuers of securities half-yearly reporting becomes mandatory.

[16] See Modernisation Directive, Article 1 No. 14 amending Article 46 of the 4th Directive and Article 2 No. 10 amending Article 36 of the 7th Directive.

[17] See Directive 2004/109/EC of 15 December 2004 on the harmonisation of transparency requirement (Transparency Directive). Official Journal of the European Union L 390/38 of 31 December 2004.

[18] The requirements include issuers of shares and issuers of debt securities. Already in 1999 the Commission communicated an "Action Plan" which stressed the need to upgrade transparency requirements. See EUROPEAN COMMISSION, Implementing the framework for financial markets: Action Plan (1999).

Furthermore a higher frequency of interim information is required for share issuers. Hence they are also required to publish interim management statements during the first six months and the second six months of the financial year.[19]

In the Transparency-Directive article 5 states that the half-yearly financial report shall comprise an interim management report.[20] This report shall include at least an indication of important events that have occurred during the first six months of the financial year, and their impact on the condensed set of financial statements, together with a description of the principal risks and uncertainties for the remaining six month of the financial year.[21] Hence the main elements of the management report will have to be updated semi annually and have to be presented as a component of the interim financial report. Though this Directive has not yet been transformed into national law it will have a great impact on national interim management reporting, since it exceeds national regulations.[22]

E. Research project of the IASB

So far no IFRS-Standard for annual reporting or a similar reporting instrument is in place, although at the same time there is a strong interest worldwide to standardize information for complementing and commenting on the financial statements. Therefore the IASB will publish a discussion paper on its research project Management Commentary/MD& A in the second half of this year. Participating in this research project besides the German Accounting Standards Committee are the IASB-liaison partners Great Britain, Canada and New Zealand, the latter having the lead.[23]

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[19] See Regine Buchheim and Philipp Ulbrich, *EU-Transparenz-Richtlinie: Neuregelung der periodischen und laufenden Berichterstattung kapitalmarktnotierter Unternehmen*, KAPITALMARKTORIENTIERTE RECHNUNGSLEGUNG (KOR) 273, 287 (2004).

[20] In contrast to the 4th and 7th Accounting Directives the Transparency Directive refers to Management Reporting rather than Annual Reporting.

[21] See Article 5 No. 4 of the Transparency Directive.

[22] Until now only issuers of shares are covered by national regulations See *Börsengesetz (BörsG)* § 40 *Zwischenberichterstattung* (Interim Financial Reporting). For further information about the impact of the Transparency Directive see Anton Burger, Philipp Ulbrich and Karsten Luce, *Kapitalmarktorientierte Rechnungslegung und Konsolidierungspflicht der Sparkassen*, BETRIEBSWIRTSCHAFTLICHE BLÄTTER 96, 105 (2005).

[23] See www.iasb.org/meetings/iasb_observernotes.asp for Observer Notes of the IASB meeting in February 2005 and the current status of that project.

Ultimately the annual report is going through as much of a dynamic development as the national and international efforts to develop accounting standards for recognition and measurement. Due to the fact that all companies with limited liability – including non-capital market oriented companies – have to publish an annual report, a large part of the German economy will be affected by the changes introduced by *BilReG* and GAS 15.[24] Further European and international efforts to harmonize information which complements and supplements the annual accounts should concentrate on capital market oriented companies. Depending on the listing either in the Unites States of America or the European stock markets these companies are exposed to different and sometimes repetitive reporting requirements. A single international standard could help to harmonize and to improve existing requirements on annual reporting.

[24] According to the Accounting Directives and the HGB, small companies with limited liability are exempted from the preparation of an annual report.