

# ANNUAL REPORT

## A Means for Corporate Governance and Transparency



Abdul Rahim Suriya, FCA  
Haroon Tabraze, FCA

### Corporate Governance

The corporate sector in Pakistan has had its fair share of corporate failures, scams and scandals - Taj Company, Mehran Bank, Islamic Investment Bank various Housing Cooperative Societies Schemes, and other numerous finance companies have deprived thousands of small investors of their life-savings. In the not so distant past, nationalized banks have written off billions of rupees by way of bad loans. These scams bear similarity to those happening across borders; with the largest occurring in USA. The victim in most cases being the general public, leads to a hue and cry over regulating the companies. After ENRON and other similar cases, financial experts from world over sat together to formulate a strategy and came to a conclusion which the medical profession discovered decades ago: "prevention is better than cure". Thus the concept of corporate governance was born.

### HISTORY

At independence, Pakistan inherited the political heritage of the United India including the Indian Companies Consolidation Act, 1913, which was duly adopted. The Act

remained in force till 1984 when the Companies Ordinance 1984 was promulgated. It is still remains in force, although amendments are usual and regular feature.

The corporate sector in Pakistan is primarily regulated by the Securities and Exchange Commission of Pakistan (SECP) through the Companies Ordinance, 1984. Various specific laws to regulate specialized corporate entities are in place i.e. Modaraba Companies and Modarabas (Floatation and Control) Ordinance, 1980, State Bank of Pakistan Act 1956, the Insurance Ordinance, 2000 etc.

### ICAP'S ROLE

One of the main developments in corporate governance in Pakistan has been the formulation of a Code of Corporate Governance (CCG). The Code was developed on the initiative of the Institute of Chartered Accountants of Pakistan (ICAP) after the members passed a resolution in the Fifth All Pakistan Chartered Accountants' Conference held in December 1998. A committee was

later formed which included representatives from various stakeholders i.e. KSE, SECP etc and a set of recommendations were formulated. These recommendations after being exposed to members of ICAP and the general public in 2001 were taken up by SECP for processing and made part of the respective listing regulations of the three stock exchanges. In 2004, Pakistan Institute of Corporate Governance (PICG) was established with the objective to provide enabling environment for the implementation of CCG issued by the SECP. ICAP was one of the founding members along with SECP, SBP, stock exchanges in Pakistan, banking and insurance associations, apex bodies of the corporate businesses, FPCCI, Institute of Corporate Secretaries and Non-Bank Financial Institutions (NBFIs) and the leading business educational institutions like LUMS and IBA.

In 2008 ICAP developed a Guide (MIES-19) in Partnership with the Center for International Private Enterprise (CIPE), and PICG. The Guide establishes principles and practices aimed at helping directors of family owned companies in improving governance.

## Annual Report and Good Corporate Governance

### TRANSPARENCY

The buzz word in today's business is transparency. Illustratively, standing outside a window would provide you with a view of what is in the room. A transparent window will give you a complete and detailed view, while a window with dark tinted glass might not show you the dirt and grime inside. Using the analogy, a financial report should be such that the reader can see inside-out of the company.

The publication of timely annual report which fulfils the requirement of Companies Ordinance is an important tool for promoting accountability and transparency in the Corporate Reporting. Of course transparency is important only when shareholders are diverse and widespread i.e. in listed entities. Detailed information is not expected from closely held or family owned companies. The last decade has witnessed the financial disclosures increasingly getting improved through international accounting standards and IFRSs to achieve the transparency desired by the readers. However the numbers are only quantitative; they lack the description of qualitative factors. The operational management for their decision making still prepare a different set of management accounts. However Management Commentary along with financial numbers is necessary for a better understanding of the operating results and financial/investing activities of the business

### ROLE OF PROFESSIONAL INSTITUTES

For the last 11 years the Joint Committee of ICAP and ICMAP has been organizing the Best Annual Report Competition with the objectives:

- to encourage and give recognition to excellence in annual corporate reporting; and
- to promote corporate accountability and transparency through the publication of:

- timely;
- factual information; and
- reader friendly information.

It is interesting to note that there although is no specific law requiring an entity to produce and publish annual report there are various statutes that require the contents embodied in it. According to the International Standard on Auditing # 720 the Annual Report is defined as "An entity ordinarily issues on an annual basis a document which includes its audited financial statements together with the auditor's report thereon. This document is frequently referred to as the "annual report".

However in order to encourage transparency and better and relevant reporting from companies through additional disclosures, ICAP and ICMAP launched the Best Corporate Reporting Awards. The awards are given to companies as an acknowledgement for voluntarily providing relevant and timely information to the stakeholders to help them make economic decisions. An elaborate 'Criteria' which has evolved over the years, is used as a basis to evaluate best reports. The criteria for 2011 includes certain information in addition to the disclosures required by corporate laws in practice, such as:

#### Ref. Criteria

- 2.0 Disclosures of information required by the IFAC Management Commentary
- 2.1 Description of nature of business including a macro-level (e.g. industry, main markets, and legal environment) and a micro-level (e.g. business model, product portfolio) discussion.
- 2.2 Explanation of management's objectives and its strategies for meeting those objectives including priorities for action and addressing threats and opportunities of market trends.
- 2.3 Description of the entity's most significant:
- 2.4 Resources, including an analysis of liquidity, cash flows, financing arrangements, human capital and capital structure, including any inadequacies in the capital structure and plans to address such inadequacies;
  - a) Risks, including strategic, commercial operational and financial risks; and
  - b) Relationships, which are likely to affect performance and value of the entity
  - c) Description of the entity's financial and non-financial performance (results) and the future prospects, including whether the performance may be indicative of the future performance.
  - d) Description of critical performance measures and indicators which management uses to measure performance of the entity against stated objectives of the entity and whether the indicators used currently will continue to be relevant in the future.

- 2.6 Market share information preferably from an independent source
- 4.2 Summary of the Cash Flow Statement for 6 years
- 4.4 Vertical and Horizontal analysis of Balance Sheet and Profit and Loss Account for 6 years
- 4.5 Statement of Value Added and how distributed
- 4.6 Investors' Relations section on the corporate website
- 5.4 Comprehensiveness of corporate information
- 5.6 Definition and glossary of terms / Calendar of major events during the year
- 6.3 Board structure and its committees
- 6.4 Chairman of the Board other than the CEO
- 6.5 Information on other Board Committees, their terms of reference and the number of meetings
- 6.6 Salient features of the Audit Committee Charter/Terms of Reference
- 6.7 Name of independent directors / non-executive directors
- 6.8 Profile of each director including engagement in other entities
- 6.9 Non- executive directors on the Audit Committee
- 6.10 Organization Chart
- 6.11 Disclosure of criteria to evaluate Board's performance
- 6.12 CEO performance review

It is pertinent to note here that the 'Criteria' not only comprises of mandatory requirement of Companies Ordinance 1984, and the code of corporate governance, it also encourages adopting international best practices. The Joint Committee of ICAP and ICMAP always looks out for new trends in information sharing and one item that stands out is the concept of 'Management Commentary'.

### Management Commentary

Management Commentary is a narrative report accompanying, but not part of, the financial statements. It tells the story about the company's performance and financial conditions as seen through the eyes of the management. The commentary describes both financial and non-financial information, and is a basis of understanding for the reader by providing a context to interpret the financial position, operating environment, and key indicators of the company.

The International Accounting Standards Board (IASB) which is the independent standard-setting body of the IFRS Foundation, had set up a project team comprising representatives from the national standard setters in Germany, New Zealand, United Kingdom, and from Canadian Institute of Chartered Accountants, to examine the potential for issuing a formal guidance on management commentary.

Subsequently, a practice statement was issued on 8th December 2010. Sir David Tweedie, Chairman of the IASB, said on the occasion:

*"Management commentary is one of the most interesting parts of the annual report. It provides management with an opportunity to add context to the published financial information, and to explain their future strategy and objectives. It is also becoming increasingly important in the reporting of non-financial metrics such as sustainability and environmental reporting."*

*"The publication of this Practice Statement will benefit both users and preparers by enhancing the international consistency of this important source of information".*

The Practice Statement applies only to management commentary and not to other information presented in either the financial statements or the broader financial reports. It should be applied by entities that present management commentary which relate to financial statements prepared in accordance with IFRSs.

A good management commentary should provide managements view not only on what has happened, but also management's reasoning of its occurrence, as well as an estimate of future, based on the past events.

A good commentary should not repeat what is in the financial statements, rather should clarify and describe the implications.

### PURPOSE

The IFRS Practice Statement Management Commentary provides a broad, non-binding framework for the presentation of management commentary that relates to financial statements that have been prepared in accordance with International Financial Reporting Standards (IFRSs).

The Practice Statement is not an IFRS. Consequently, entities applying IFRSs are not required to comply with the Practice Statement, unless specifically required by their jurisdiction. Furthermore, non-compliance with the Practice Statement will not prevent an entity's financial statements from complying with IFRSs, if they otherwise do so.

### Futuristic information

Management commentary should communicate management's perspective about entity's direction. It should include forward looking information when it is aware of trends, uncertainties or other factors that might affect the entity's liquidity, capital resources, revenues and results.

Management should also disclose the assumptions used in providing forward looking information as well as the Management's assessment of the entity's prospects in the light of current period results.

### VARIANCES WITH PREVIOUS YEAR TARGETS

Management should explain how and why the performance of the entity is short of, meets or exceeds forward-looking disclosures made in the prior period management commentary. For example, if management stated targets for future performance in previous reporting periods, it should report the entity's actual performance in the current reporting period and analyze and explain significant variances from its previously stated target as well as the implications of those variances for management's expectations for the entity's future performance.

### WHAT DOES MANAGEMENT COMMENTARY INCLUDE

Focus of the management commentary depends on the facts and circumstances of the entity. It generally includes:

1. **Nature of Business:**
  - a. The knowledge of the business in which a company is engaged, its external environment including a discussion of the industry sector to which company belongs.
  - b. A discussion of primary and secondary markets and company's position in the market
  - c. The legal, regulatory and economic environment that may have an influence on the company as well as on the market in which the company operates.
  - d. The company's structure, organization, products, services, business processes and distribution channels.
2. **Objectives and Strategies:**
  - a. A discussion on strategies adopted by the company, and their respective results
  - b. Likelihood of continuing these strategies and estimated results in future
3. **Resources:**
  - a. The most important resources available to company including human, and capital resources
  - b. The company's ability to sustain and maintain these resources in future
  - c. A discussion on company's strategy on how to generate resources in future

4. **Relationships**
  - a. Significant relationships of the company with stakeholders
  - b. How these relationships effect the performance and value of the company
  - c. How these relationships are managed and strengthened
5. **Risks:**
  - a. A discussion on the risk identification process adopted by the management.
  - b. Plans and strategies of how to mitigate material risks and uncertainties
  - c. Negative consequences and potential opportunities related to material risks
6. **Results and prospects**
  - a. A clear description of the entity's financial and non-financial performance
  - b. Management's assessment of entity's prospects
  - c. Analysis of the managements objectives and strategies with the entity's result
  - d. Comparison of current performance with prior periods to help understand the extent to which past performance may be indicative of the future prospects
7. **Performance measures and indicators**
  - a. Narrative description of the effects of key financial indicators
  - b. Explanation of why and how past performance differs with current performance
  - c. Explanation of any change in the relevance of performance measurement indicators

### MANAGEMENT COMMENTARY VERSUS DIRECTORS REPORT:

**The difference:** In this context it is important to note that "management here means the people responsible for decision making and oversight of the entity. They may include executive employees, key management personnel and members of a governing body.

Management commentary is not directors' report, although it is usually assumed to be so. Management commentary is recommendatory but not mandatory. After all it is not IFRS.

The Directors' report generally consists of review and trend analysis of the performance of the company over a period of time. It covers the performance limited to the earnings and distributions over the period. In contrast the Management Commentary is aimed at providing the users information regarding strategies established to achieve the targets. Furthermore it also requires management to provide an analysis of any shortcomings in the achievements with reference to these strategies followed by the management. In fact the management commentary requires such information for the users to analyze the sustainable growth of the entity including information related to the available resources and future strategy to maintain and or enhance according to the needs in future.



## COVER STORY

information which is now addressed by the Management Commentary:

- Explanation of strategies for meeting management's objectives e.g. threats and opportunities of market trends.
- Analysis of liquidity, cash flows, financing arrangements, human capital and capital structure and the company's ability to maintain these resources and strategy on how to generate resources in future.
- Description of the entity's most significant relationships, which are likely to affect performance and value of the entity and how these relationships are managed and strengthened.
- Description of the entity's most significant risks and related consequences and opportunities and plans and strategies to mitigate material risks and uncertainties.
- Description of critical performance measures and indicators which management uses to measure performance of the entity against stated objectives of the entity.
- Narrative description of the effects of key financial indicators.
- Explanation of why and how past performance differs with current performance

short, meets or exceeds forward looking disclosures made in the prior periods.

- Significant changes in an entity's objectives and strategies from the previous period or periods.
- Risk plans and strategies for bearing risk or mitigating risks and effectiveness of these strategies. Principal risks facing the entity should cover both exposures to negative consequences and potential opportunities.
- The significant relationships that the entity has with stakeholders, how those relationships are likely to affect the performance and value of the entity, and how those relationships are managed.
- The relationship between the entity's results, management's objectives and management's strategies for achieving those objectives.
- Significant changes in financial position, liquidity and performance compared with those of the previous period or periods.
- Analysis of the prospects of the entity which may include targets for financial and non-financial measures. For targets, if quantified, management should explain the risks and assumptions necessary for users to assess the likely hood of achieving those targets
- Why the results from performance measures have changed over the period or how the indicators have changed.

There are few areas of Management Commentary which

### GAP with BCR Criteria

are neither part of Companies Ordinance / Code of Corporate Governance nor in the Criteria for Best Corporate Report for 2011. Management should disclose in order to bring more transparency:

- The information that is important to management in managing the business
- Perspective of the entity's direction
- Forward looking information when management is aware of trends, uncertainties or other factors that could affect the entity's liquidity, capital resources, revenues and the results of its operations. Forward looking information may be narrative explanations or quantitative including projections or forecasts.
- How and why the performance of the entity is

### About the Authors:

Abdul Rahim Suriya is a fellow member of ICAP and ICMAP. He is past President of ICAP and presently a council member. He has over 27 years experience in Accounting, Auditing, Corporate Finance and Operational Management. He is a professional trainer on the subject of "Finance for Non Finance Executives" and has recently authored a book on "A guide to Business Decision Making". He is a practicing CA and runs his firm "A.R.Suriya and Co, Chartered Accountants ". For details visit [www.arsuriya.com](http://www.arsuriya.com)

Haroon Tabereez is a fellow member of the Institute of Chartered Accountants of Pakistan (ICAP) and Director of Technical Services at the Institute.