Get your reporting right

COMPANIES THAT IMPROVE THEIR DISCLOSURE OF DEBT AND CASH FLOWS WILL GET A BETTER RECEPTION FROM INVESTORS. SUE HARDING HIGHLIGHTS SOME USEFUL ENHANCEMENTS THEY CAN MAKE

The Financial Reporting Council's Financial Reporting Lab (the Lab) has published three reports relating to debt and cash flow disclosure: *Net debt reconciliations*, *Debt terms and maturity tables* and *Operating and investing cash flows*. These reflect the views of more than 30 individuals from 16 investment organisations on information that matters to their decisions. The reports highlight mainly voluntary information that is important to investors, when and why it is important, and how it is used.

The Lab's work was conducted with the help of five companies whose disclosures are used in the reports to illustrate many of the reporting practices favoured by the investment community: BT, National Grid, Royal Dutch Shell, Vodafone and Xchanging.

In particular, the reporting practices could help companies that have significant levels of debt or plans to approach the market for funding in the future, to communicate certain key information effectively. For example, even small changes in how a company discloses the amount of debt it has and when it is due, shows cash and non-cash changes in net debt over the period, and presents the relationship between operating profit and operating cash flow, can make the difference between providing quite useful information and information that leaves unanswered questions and uncertainty in the minds of investors and analysts.

One analyst participating in the project commented that reconciliations of net debt and information on debt terms and cash flows "answer questions of potential sellers rather than persuade buyers". This can prove crucial when questions arise in relation to a specific company or even its peer group.

One company participant urged companies to "help yourselves to get the investor relations

IS YOUR COMPANY DISCLOSING INFORMATION THAT INVESTORS WOULD FIND IMPORTANT?

Below is a selection of reporting suggestions that companies may be able to address based on information that is already to hand if they are not currently doing so. Has each relevant suggestion been implemented by your company?

NET DEBT RECONCILIATIONS

- Do you provide a net debt reconciliation and/or a reconciliation of net cash flows to changes in net debt? If these are prepared internally, consider providing them externally.
- Is it clear what the company manages as net debt, and how it relates to amounts on the balance sheet?
- Are different changes shown separately, for example, FX movements and any fair value movements?

DEBT TERMS AND MATURITY TABLES

Are the following questions answered?

HOW MUCH DEBT IS OWED?

- Are the following shown for each significant borrowing: principal borrowed, currency of denomination and carrying amount on the balance sheet?
- Does the contractual maturity table show a total amount for principal payments and is this related to the carrying amount in the balance sheet?

WHEN IS IT DUE?

- Are maturity dates (month and year) shown for each significant obligation?
- Does the contractual maturity table split out amounts for each of the first five years?

WHAT IS THE COST OF DEBT?

- Are interest rates disclosed by obligation and on an aggregate, weighted average basis?

HAS DEBT BEEN HEDGED?

- Is it clear how individual obligations and the overall currency and interest rate profile are altered by hedging?

OPERATING CASH FLOWS

- Does the statement of cash flows include the reconciliation of profit or loss to operating cash flows at the top rather than in the notes?
- Does this reconciliation start with operating income or loss, or if starting from another figure such as net profit, does it reconcile this to a subtotal for operating income or loss? This may simply mean reordering items on the statement to insert such a subtotal.
- Are separate changes in the components of working capital (and other differences between operating income or loss and operating cash flows that are specific to the business) listed?
- Do the descriptions of line items link easily to the related items on the balance sheet and explain the nature of each item – whether an item is from the income statement, a cash flow or a difference between the two?

department focused on explaining where the company is going and providing the key [strategic] messages by putting into your reports clean and crisp reconciliations" of debt and cash flow information that effectively provides the basic information.

Net debt reconciliations

Disclosing how net debt changes over the period provides investors with a basis for anticipating future cash and non-cash changes and potentially avoiding surprises. If significant, net debt is also a key component of equity valuation. Yet many companies do not provide reconciliations.

Investors generally cannot reconcile net debt themselves based on information disclosed (try it!). This is particularly the case if a company has significant changes in debt for acquisitions, disposals, fair value or fair value hedge accounting, or FX.

Investors will often start their analysis with the company's reported information and what it manages as net debt. Some companies adjust for the retranslation of foreign currency denominated amounts to the exchange rates achieved hedging, as this gives visibility of the economic obligation after hedging.

While net debt reconciliations typically show the movements in net debt by component, reconciliations of net cash flows to changes in net debt relate the cash changes in net debt to information on the statement of cash flows.

The reports highlight information that is important to investors

Some companies also extend the reconciliation to link it to other key figures communicated, for example, starting with EBITDA. This confirms the relationship between various figures a company uses to communicate to the market.

Investors suggest providing reconciliations as soon as, and as often as, a company reports – in preliminary announcements and interim reports – and including them in the audited section of the annual report. This provides additional comfort, but investors would rather have 'unaudited' reconciliations than none at all.

Debt terms and maturity tables

The extent of information disclosed by companies on debt terms varies. For investors, this can give rise to questions and hampers analysis at a common level of detail when investigating particular risks or problems across companies or even just forecasting interest.

Tables showing the contractual payment obligations for debt can be made more useful by separately showing principal and interest, and linking principal to the reported amount of debt on the balance sheet. This indicates how close the overall carrying amount is to the amount to be repaid.

Regarding when debt is due, disclosure of maturity month and year of each obligation, along with maturity tables that show annual amounts for each of the first five years, are considerably more helpful than, for example, a total for years two to five.

Operating and investing cash flows

One of the key issues investors want to understand from financial statements is the conversion of operating profits to operating cash flows. Most want to see separate disclosure of changes in individual components of working capital, in order to understand the company's definition of working capital and the drivers of change in specific components.

As with changes in net debt, investors themselves often cannot calculate the separate changes in balance sheet amounts.

WHAT IS THE FINANCIAL REPORTING LAB?

- **The Financial Reporting Lab has been set up by the Financial Reporting Council to improve the effectiveness of corporate reporting in the UK.**
- **The Lab provides a safe environment for listed companies and investors to explore innovative reporting solutions that better meet their needs.**
- **Lab project reports do not form new reporting requirements. Instead, they summarise observations on practices that investors find useful to their analysis and encourage companies to consider adopting the practices, if appropriate in the context of their own reporting.**
- **Download copies of the three reports or find out more about the Lab, including information about other projects, at: www.frc.org.uk/Our-Work/Codes-Standards/Financial-Reporting-Lab.aspx**

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