

## I. CONSISTENCY OF NARRATIVES

### Analyzing and Auditing of Management Report

Narrative reporting information is defined as all annual report content published by companies other than the financial statements, notes and the auditors report. This broad definition of narrative reporting includes all contextual information that accompanies the financial statements and, despite its name, is expressed in narrative, quantitative, financial or non-financial terms, which could be compulsory or voluntary disclosure.

Financial information alone is not enough for proper assessment of a company's future. There are some drivers of company performance that cannot be expressed in financial terms. The extant system of financial accounting fails to capture the risks, opportunities and interdependent organisational relationships of businesses operating in modern, increasingly knowledge-based environments. Narrative reporting has developed as an outlet for management to disclose present- or future-oriented information demanded by those users seeking to appraise strategy, management quality and firm-specific intangibles. Therefore, regulators have increasingly mandated or recommended specific, detailed narrative disclosures.

What is management commentary report?

- A narrative report that provides a context to interpret the financial position, financial performance and cash flows of an entity.
- It provides management with an opportunity to explain its objectives and its strategies for achieving those objectives.
- An important element of communication with the capital markets, supplementing as well as complementing the financial statements.

Purpose of the management commentary?

- Provide users of financial statements with integrated information that provides a context for the related financial statements. Such information explains management's view.
- Complements and supplements the financial statements by communicating integrated information about the entity's resources and the claims against the entity and its resources
- Explain the main trends and factors that are likely to affect the entity's future performance, position and progress.

Elements of narrative management commentary:

- (1) The nature of the business
- (2) Management's objectives and its strategies
- (3) The entity's most significant resources, risks and relationships
- (4) The results of operations and prospects
- (5) Critical performance measures and indicators

The Accounting Directive<sup>1</sup> does not only contain a framework for member states' accounting rules in cases where IFRS standards are not used. It also sets rules for auditing, including the management report. Art. 34 (1) a) i) requires auditors to express an opinion on whether the management report is consistent with the financial statements for the same financial year:

*"Article 34 General requirement*

1. Member States shall ensure that the financial statements of public- interest entities, medium-sized and large undertakings are audited by one or more statutory auditors or audit firms approved by Member States to carry out statutory audits on the basis of Directive 2006/43/EC.

The statutory auditor(s) or audit firm(s) shall also:

(a) express an opinion on:

- (i) whether the management report is consistent with the financial statements for the same financial year, and
- (ii) whether the management report has been prepared in accordance with the applicable legal requirements;"

Assessing the consistency between quantitative and qualitative information can be a difficult task. Scores that summarize important language tendencies in a quantitative measure can help in this discussion. An example of different language poles may be positive ("pleasing") vs. negative ("stagnant") words. This is often called sentiment.

## Case Study Company in Trouble

Every year the CEO of XFashion reports about the situation of XFashion Group. The pdf files are stored in a certain directory location. The historical Earnings of XFashion Group were (in million Euros):

Year	Profit/Loss
2012	51
2013	55
2014	53
2015	44
2016	-23
2017	33
2018	18

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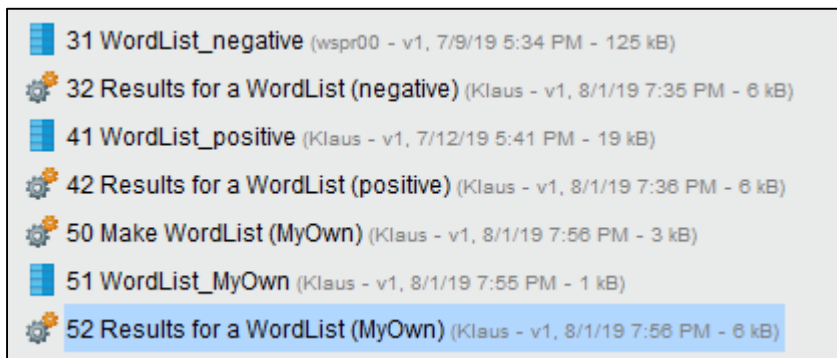
<sup>1</sup> DIRECTIVE 2013/34/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, ...

a) There are already two word lists stored in Rapidminer:

- “31 WordList\_negative” contains word with a potentially negative meaning.
- “41 WordList\_positive” contains word with a potentially positive meaning

These list were developed by Tim Loughran and Bill McDonald and are available at:  
<https://sraf.nd.edu/textual-analysis/resources>.

In the repository you also can find software code named “32 Results for a WordList (negative)” and “32 Results for a WordList (negative)”.



If you run the code it splits the text of each pdf file in the directory (i.e. each report of the chairman) into its separate words and counts the occurrence of all words that are on the word list. The output is shown in three different ways:

- A count for all words on the word list  
(however, the count for specific words might be zero in every report).
- A count for all words on the word list that appear at least once.
- The sum of counts for the whole word list.

Compare the results with profits over time!

b) Are there other words where you believe counting and comparing their frequencies over time might be informative?

- Explain the reason for it.
- Open “50 Make WordList\_(MyOwn)” and follow the instruction inside to create your own word list.

**Attention:** This simple code version does only allow for single words, not combination of words! Certainly word combinations (so called 2-grams or 3-grams) are possible, but that would make the code more complex.

- Start “52 Results for a WordList (MyOwn)” to apply your word list to the reports.
- Did you get your expected results?