BIS Department for Business Innovation & Skills

SUMMARY OF RESPONSES

The Future of Narrative Reporting – A Consultation

DECEMBER 2010

Contents

Introduction

Consultation process

1. The consultation on The Future of Narrative Reporting ran from 2 August to 19 October 2010. It had three objectives:

- To improve the quality of company reporting to their shareholders
- To empower shareholders to hold directors to account on their performance
- To make sure that any measures we introduce will improve the quality and relevance of disclosures and not just add to them

2. Before the consultation Edward Davey, Minister for Employment Relations, Consumer & Postal Affairs met representatives from the business and investment communities and other stakeholders. During the consultation BIS ran three consultation workshops to discuss the issues raised by the consultation. These were attended by 40 representatives from companies, business organisations, investors and other stakeholders.

3. After the consultation closed the Minister held a roundtable discussion with 26 interested parties to discuss the emerging findings and possible options. On 29 November BIS and HM Treasury published the Growth Review http://www.bis.gov.uk/growth which sets out what we are doing to create the best conditions for private sector growth. Corporate governance including narrative reporting is one of the Government's priorities for action in that review. As part of this programme, we will be bringing forward policy proposals by Budget 2011. Meanwhile this document provides a summary of the responses to the Future of Narrative Reporting consultation.

Responses to the consultation

Category[1]	Total	
Companies & Business Representative bodies	20	22%
Investors & investor representative bodies	18	20%
NGOs & Trade Unions	13	15%
Lawyers & accountants	13	15%
Other	25	28%
Total	89	100%

Analysis of Themes

4. A more detailed analysis of the responses to individual consultation questions is set out in the sections below. However, a number of key themes emerged from responses and the consultation workshops which are summarised here. Some noted that in general UK companies produce high quality reports. Nonetheless, there remained room for improvement particularly at the tail end where compliance with the letter rather than the spirit of the legislation was limiting the value of disclosures. A number of respondents noted that standards had improved over recent years particularly since the business review came into force in October 2007. These changes were still bedding down and others such as the new provisions on business model in the Corporate Governance Code and the Stewardship Code were too new to have had an impact: practice was therefore still developing suggesting further regulatory change might be premature. Many noted the complexity and overlapping requirements of the current regime which pointed strongly to the need for a more thorough going look across the whole of the narrative reporting landscape to streamline the framework and achieve a

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[1] Where respondents did not state what category they were in, they have been assigned to the definition which appeared most appropriate

significant step change in disclosure practice.

5. Some investors noted that disclosure of company strategies, risks and opportunities was essential in enabling them to make informed decisions on the likely long term performance of their investments. While this confirmed the value of good quality narrative reporting, there remained a question about the purpose of the annual report when many investors rely on other more timely sources of information for their decision making. Equality of access to critical business information was noted – big investors appearing to have greater access to useful information than either retail shareholders or other stakeholders.

6. Tensions arose for companies in attempting to meet the varying information needs of a range of users including regulators, investors and other stakeholders. The price of trying to satisfy diverse interests might be overlong and inaccessible reports which failed to provide relevant, consistent or comparable data. However, views on what constituted relevant data varied. Reporting of social and environmental matters in particular was viewed by some as poorly integrated into the strategy and risks of the business and as a result did not provide relevant and consistent information. Equally there were concerns that reports were too often a marketing exercise rather than presenting a balanced and fair view.

7. The tension of comparability versus the need to reflect the unique nature of individual companies was a strong theme resulting in very different views on many questions. Audit and assurance was also raised as an area needing further thought.

8. Many also noted the various existing initiatives to encourage good reporting such as regular surveys of good practice and awards as well as the role of the Financial Reporting Council (FRC) and its operating bodies in providing best practice guidance and in assessing compliance with accounting and legal requirements. Was there scope for strengthening any of these elements?

9. The differences in opinion tended to be consistent with respondent type and reflected divergent views on the quality of existing reporting as well as the best approach to improving current standards. The responses to some questions tended to overlap significantly but in the analysis below, key points have been grouped under the question which seemed most relevant rather

than repeated under every question

Summary of responses to consultation questions

Value of narrative reporting

Consultation question
<u>Question 1</u>: Are company directors providing useful and relevant information on the company's: **i) forward-looking strategy and** **ii) principal risks and opportunities?**

10. There were mixed views on this question. **Companies and business representative bodies** generally felt they aspired to provide useful and relevant information on these issues which was supplemented by other forms of investor communications. However a number noted the constraints which limited their disclosure (see Question 2).

11. Various studies were cited[*] by all respondent groups which assessed the levels of compliance with the reporting requirements on strategy and risk. These tended to support the view that levels of compliance and quality had improved over time. However, the quality of disclosures on forward looking strategy and risk were still variable – there was a tendency for the larger listed companies and those under significant public scrutiny to perform better. Some professional bodies also noted a renewed focus on these issues in the wake of the financial crisis which meant it was ever more necessary for the narrative to explain complex financial reports. Some noted that the new requirements of the Corporate Governance Code in particular on the role of non executive directors and on coverage of the business model would help in future.

12. Investors and investor bodies considered that practice was patchy and often unsuitable for forecasting future performance. Strategy was generally focused on the past rather than the future and tended to be too broad. Often risks were too generic, lacked time horizons and were not limited to the principal risks affecting the business – as one respondent described it, too

[*] For a list of sources cited by respondents and referred to in this summary see Annex B.

often the risks were related simply to being in business rather than explaining the factors likely to affect the individual company's ability to achieve its strategic objectives. A common concern was that risks were not linked clearly to company strategy and it was not always clear how those risks were being managed. Some voiced concerns that relevant information was hard to find because a compliance approach was resulting in the inclusion of too much data. Risk data might be found in different parts of the report which did not aid coherence. Equally there was a concern that reports were too often seen as marketing opportunities and might lack balance and candour.

13. NGOs and Trade unions generally considered that company reports often failed to explain how companies were managing issues such as human rights, environmental impacts or employee matters where these had material implications for their strategy and risk management. There were also concerns that the data was inconsistent making cross sector comparisons difficult.

Consultation question
<u>Question 2:</u> What are the constraints on companies providing information on these issues?

14. A fairly consistent picture of the most common constraints emerged from a majority of respondents. These included:

- Commercial sensitivity
- Liability concerns in particular if risks were missed or forward looking projections were not realised
- Complexity of the reporting regime
- Lack of time and resource for smaller quoted companies
- Lack of incentive for companies eg insufficient investor demand as well reliance on other sources of information
- Inability to satisfy the interests of a range of users
- Impact of legal/audit oversight diluting the quality of the information
- Compliance with US rules for dual listed companies

15. Other constraints cited less frequently included:

- Lack of coherence in the production of the report and lack of Board

direction or leadership
- Tension between the long term nature of some risks and short term horizons
- Tendency to follow the pack and a wish to avoid setting a precedent
- Lack of guidance, standards or sufficient regulatory oversight (mainly cited by NGO/other stakeholders).

Consultation question

Question 3: Does the information provided reflect the issues discussed by the directors in board meetings?

16. Company respondents considered that reports reflected the relevant aspects of their Board discussions to the extent that was appropriate bearing in mind some of the constraints mentioned above such as commercial sensitivity and liability concerns. In practice board discussions would range quite widely and should be frank but only relevant information from those discussions relating to the key issues facing the business should be disclosed.

17. Other respondents noted they were not in a position to judge clearly to what extent disclosure reflected the board's discussion and one investor suggested that Independent board evaluations available to investors might help. From their knowledge of companies the following observations were made:

- The report should reflect the directors' view of the strengths and weaknesses of the business ie a report "through the eyes of management" – it should not be delegated to others for example, communications or investor relations teams with limited direction from the Board.
- Some issues were considered in more depth at committee rather than at Board level for example, audit, remuneration and CSR matters or were not properly addressed for example, employee matters and so were not reflected in reports. Conversely others felt that some environmental and social matters were discussed by the Board but that information did not find its way into the reports.
- While some felt that reports reflected the Board's focus on strategy and risk, others noted limitations in how reports set out the Board's role on

strategy formulation as noted under Question 1. Conversely reports may include information on more risks than those considered central by the Board.

- There was some concern that a requirement to disclose more detail of discussions could be counterproductive.
- Some respondents suggested that the reporting framework should provide a focus for Board discussions rather than the other way round i.e. the issues to be covered in the report should drive the board agenda
- As mentioned under Q1 the new Corporate Governance Code provisions requiring Boards to explain the business model might help
- Given the often vague quality of reports, an investor doubted that they reflected Board discussions – a view which may be consistent with the comments made by companies on the limits to disclosure (Q2).
- One respondent also noted a disconnect between external financial reporting which used historic data and internal management reporting which used more real time information.

Consultation question

Question 4: Does the information help shareholders to press directors on key issues relating to strategy and risk, or inform their business decisions?

18. Questions 4 & 5 were not aimed at companies who therefore had limited comments to make. Some **companies** nonetheless said they would look to meet investors' information needs subject to any constraints of confidentiality but relied on investors to let them know what they wanted. However, the type of investor ie institutional or retail and their objectives and style would determine how active they were and what information over what time horizons they valued. Another respondent also noted that companies were trying to serve two masters: shareholders and regulators whose needs might not be compatible.

19. Investors and investor bodies were the primary audience and key points were as follows:

Good narrative reporting was valuable but coverage and quality was variable with some issues not necessarily covered adequately for example, environmental performance. Investors did not rely on narrative reports principally to inform their decision making - they relied on other sources of information which were provided on a timely basis through the year such as financial statements, analyst reports, company briefings. The annual report was however valuable as a confirmatory and holistic picture of the company focusing on both historic and forward looking information to enable an assessment of the Board's stewardship of its resources. Investors would use all available sources in their analysis which would inform their engagement.

20. In some cases, the information in narrative reports might be inconsistent with a shareholder's understanding of the key issues for the business and that disconnect would often prompt engagement with the company.

21. Retail investors would have less access to other sources of information and were not always engaged on strategy and risk. One suggested they might generally find the Summary Financial Statement more useful than the annual report.

22. One respondent proposed that a short form report supported by detail elsewhere might help to focus communication on key issues of strategy and risk. (See also Qs 7&8)

23. NGOs and Trade unions considered that investors did not have sufficient relevant and quality information from companies on environmental and social risks to inform their assessments of the companies' prospects. Climate change, human rights and health and safety were examples where companies did not always provide adequate data – one NGO commented that those with greatest human rights impacts were least likely to report on matters of significance. Another cited a survey of fund managers where half agreed that poor quality data and lack of regulatory requirement on greenhouse gas emissions were a barrier to integrating material factors into their decision making. [2]

24. There was considerable support in this group for regulations setting a minimum standard of acceptable disclosure on these issues including company performance. In the absence of reliable and consistent data in this area, investors looked to sources such as NGOs and the media for information to inform their assessments.

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[2] Preparing for the storm? UK Fund Managers and the Risks and Opportunities of Climate Change, Fair Pensions, Oct 2009

25. One NGO noted that the volume of data inhibited a focus on relevant information. Companies also did not provide information trends or performance against benchmarks. The lack of verification of the social and environmental data undermined its credibility for investors – non financial and financial information should be subject to the same level of audit.

Consultation question

Question 5: If a company does not provide sufficient or material information to you, do you challenge it? Is there anything which could help you to do so?

26. As before this was not primarily for companies but one noted that engagement meetings would not tend to focus on strategy or risks as much as assessing the credibility and calibre of the directors.

27. Among **investors and investor bodies** there was a consensus that they did challenge companies on a range of issues where the information provided was inadequate. Good quality information was essential to high quality engagement. The nature of the challenge or engagement would vary depending on the nature of the investor such as a private meeting, filing a resolution or a public vote. Some investors engaged regularly with investee companies on environmental, social and governance issues including the option of voting against a report and accounts if material environmental, social and governance (ESG) data was not provided. Access to investee companies was easier for large investors than for retail investors but even they might find engagement difficult with some companies especially when selling shares was not an option.

28. One way of facilitating challenge would be change in the engagement process which enabled more collective action by investors without the risk of forming concert parties. Some respondents suggested that the new Stewardship Code (and provisions in the Corporate Governance Code) may help to facilitate better engagement as well as helping to clarify the aims and activities of fund managers.

29. The role of the Financial Reporting Review Panel (FRRP) in considering complaints about inadequate reporting which had been extended to cover

narrative was seen as important in achieving effective reporting: the FRRP should be better promoted and resourced.

30. Other suggestions included:

- guidance for Board directors including on how to assess the materiality of ESG issues;
- a vote on the business review or on sustainability information;
- a provision requiring the company to explain the process for example, in determining material issues; and
- whether additional assurance of the business review would be valuable to shareholders.

31. Several respondents noted that the Listing Rules required listed companies to disclose information likely to have a significant effect on share price which could be defined as material information.

32. Most **NGOs and Trade unions** did challenge companies where the information available was not adequate. Several had used shareholder resolutions notably with Shell and BP which had resulted in additional disclosure of material environmental data. Suggested options to facilitate challenge included:

- The use of shareholder resolutions was less common here than in the US and the current system was too complex and onerous; greater use of this option should be encouraged;
- Reports should be explicitly addressed to a wider audience than shareholders and companies should consult the workforce about employee matters covered in their reports.
- Legislation requiring full disclosure on environmental and social risks which would help promote more effective engagement.
- While the risk of litigation was recognised, reports sometimes presented an unrealistic picture which undermined credibility – greater realism without penalty should be encouraged.
- Investors should more consistently challenge companies on poor quality reporting.
- It should not however be left to investors/stakeholders alone who may not have the time, resource or expertise: an active Regulator should enforce compliance –the FRRP could be strengthened to clarify the

acceptable standards and then enforce them which would incrementally improve performance.

Consultation question

Question 6: What other sources of company information do you use and how valuable are they (e.g. information provided on the website, analysts' briefings, dialogue with the company, corporate social responsibility report)?

33. This question was aimed at investors and other report users. General observations were:

- There was no single user or investor and different information sources served different purposes; their use or value depended on the interests and style of the particular user.
- While they had access to other sources, retail investors relied largely on company communications.
- Credibility was a concern where users were relying on sources which were not verified. One study found that analysts saw annual reports as having the highest credibility with websites seen as significantly less credible.[3]
- Messages should be consistent across all sources of company information and timeliness of information was critical to investors.

34. The following were the most commonly used information sources:

Public data supplied by the company

- Websites – these were regarded as a valuable tool especially the search facility and interactive content. However several noted variation in the ability to access relevant data and in coverage of relevant data. It was seen as a tool which had considerable scope to improve communication and access to information if used to its maximum potential.
- The annual report and in particular the business review and the financial report were used.
- CSR reports were referred to by some but were generally seen as of

[3] Black Sun survey of 40 buy side and sell side investment professionals 2009

limited value; they did not necessarily cover key issues for the business which should more properly be covered in the business review. There was also a sense that these reports were more about public relations and lacked rigour and reliability.

- Other regulated updates for example, interim statements and other non mandated information provided by companies including company investor packs.

Other communications

- Most investors valued meetings with the company as the opportunity for a more in depth discussion on matters of particular interest to the specific audience. One business representative respondent noted that discussion on these occasions would often focus on non statutory information i.e. adjusted profit and earnings per share as much as statutory information.

Third party sources

- Analyst and other specialist research including by NGO and trade unions.
- Regulatory sources to look at particular industry performance but not all regulatory bodies for example, Environment Agency and Health & Safety Executive made their performance data publicly available.
- Market data and media reports.

35. While engagement was generally encouraged, some users cautioned that information was provided selectively to different audiences while consistent relevant good quality information should be available to the market as a whole in a single verified source such as the annual report.

Consultation question

<u>Question 7:</u> Is there scope to reduce or simplify the requirements on which companies report?

36. There was a strong divergence of views on this question with companies and some others favouring simplification of the current regime while **NGOs and Trade unions** considered the existing regulatory framework needed strengthening. Responses highlighted one of the themes emerging from the

consultation on the tension between the need for comparability and the need for flexibility to enable the individual company to present its unique “story”.

37. Companies generally agreed there was scope to simplify the framework though several respondents noted the business review provisions provided the right balance in terms of the coverage of issues and flexibility of approach. Requirements should be framed in a logical coherent manner and as far as possible as disclosure principles. An approach which helped companies to report in line with the way they manage themselves was needed. Setting more detailed or standardised requirements might aid comparability but would risk a more compliant boilerplate approach rather than greater engagement. Equally directors and auditors were wary of missing out information which others may consider necessary so might err on the side of too much information. One respondent suggested that the requirement for interim management statements could be removed or amended as a significant burden. This derived from the Transparency Directive so would need change at European level and others noted that the scope for manoeuvre in this area was constrained by European requirements.

38. Many respondents noted the different sources and volume of sometimes overlapping or conflicting regulatory requirements and guidance; this was noted as a particular challenge for companies and an area offering scope for simplification, for example, by drawing them together and eliminating duplication. The piecemeal or incremental approach which added requirements without reviewing whether existing requirements were needed was a problem. There was often duplication in reports as well as coverage of non material issues which should not be encouraged by the regulatory regime. A short form report as developed by the Institute of Chartered Accountants of Scotland* (ICAS) offered a first step to reform. However, different shareholders used the report in different ways – a retail investor might find the full report too long or technical; shareholders needed to tell companies what they wanted

39. Scope for change included removal of the business review provisions on comply or explain and on contractual relationships or guidance on the interpretation of “essential” in that context. Details of research and development were also not necessary to prescribe – where relevant this information should be in the business review. A number of other detailed provisions could be removed

40. Some respondents from the **investor** community did not welcome more change even to simplify as the existing framework needed time to bed down. One would not want to see a reduction in requirements and several felt there was a need to focus on materiality - linking strategy, principal risks and performance along with time horizons. Reporting should be proportionate to size and complexity of the company and clutter in reports could be cut with some information more appropriate for separate disclosure. Better reports did not mean longer reports - quality and usability were critical. Equally information could be presented better to facilitate navigation and with necessary cross referencing (see Q8). One suggestion was to present information in more standard and basic form for example like US Form 20 – F. There should also be greater clarity on what information was assured.

41. One investor proposed consulting a range of different sized companies from a range of sectors and their investors to see what could be simplified. Companies could address their reports to long term investors alone which would influence the issues they reported, for example human capital management.

42. Among **other respondents**, there was a view that regulators should first agree the scope and purpose of reporting and some felt the current framework was sufficiently flexible and did not need simplifying. **NGOs and Trade unions** suggested that national and international standards for reporting and disclosure should be streamlined into one mandatory framework. Regulation providing greater clarity and effective guidance would make reporting simpler, more consistent and useful. The requirements in respect of international standards on the responsibilities of business should be clarified and the earlier materiality guidance could be revised and reissued.

Consultation question

Question 8: Is there scope to arrange the information in a more useful way?

43. Coherence and clarity were recurring themes and where many felt progress could be made.

44. Companies favoured flexibility in how they chose to present the required

information particularly given the differences between companies. Presentation and order were important, for example, Key Performance Indicators (KPIs) and principal risks should be presented prominently in the report, but guidance (for example by FRC or BIS) could emphasise the quality and accessibility of information rather than where it was located. While flexibility was useful, another respondent noted that business review data was being presented in various places. To ensure important information was not lost we should support projects to reduce complexity and clutter such as that undertaken by the FRC. One business representative respondent favoured more standardised and specific headings to encourage more consistent reporting. The use of graphics, for example, diagrams and graphs should be encouraged to illustrate and explain the narrative in an accessible way.

45. Shorter summary reports on the principal strategic issues would be preferable, supplemented by separate data on websites. Many saw scope for more online reporting which could help where different users had differing information needs. Companies could include just the business review and accounts in the report with the rest of the data on a website – there would no change in total content but this approach could help accessibility. One company, for example, encouraged greater use of a high quality HTML version of their report which allowed users to order and present data –a hard copy Summary Financial Statement was also available. There could be scope to include certain narrative information in the Summary Financial Statement (see ICAS proposals for a short form model[4]). One however noted that the regulatory environment did not favour an online approach and another cautioned against a summary approach if this added to existing requirements and oversimplified complex issues.

46. Picking up a point made elsewhere on equal access to information for all types of shareholder, it should be best practice for analyst presentations to be put on websites.

47. Many **investors** wanted companies to consider the needs of investors for consistent comparable data so would welcome clear concise information with greater consistency in style and structure to aid comparison. Standard guidance could be used for some issues for example, DEFRA guidance on

[4] Making Corporate Reports Readable – time to cut to the chase ICAS

greenhouse gas emissions and time horizons should be used for the description of strategy and KPIs. Others agreed with a more consistent approach but felt this should be developed by the company to avoid a boilerplate approach. One felt there was no need for substantial overhaul - market pressure should continue to develop reporting practice. Accessibility would be helped by indexing reports and cross referencing the various areas of the report, for example with risks discussed in the context of strategy. Similarly a narrative thread which linked the subject matter in the report within an overarching story would help the user understand more easily.

48. Companies could ensure a better connection between the financial and non financial information in the report and better layouts and formatting and some welcomed the work of the International Integrated Reporting Committee which aimed to create a global framework bringing together financial, environmental, social and governance information in a consistent format.

49. Some agreed that greater use of innovative web based reporting could enable more tailored use as well as cutting costs. The development of XBRL[5] might help and some data which changed infrequently on policies or systems could go on the web. One cautioned against greater fragmentation, for example, by producing various documents as well as the annual report.

50. **NGOs and Trade unions** favoured standardised formats for reporting to achieve comparability between companies and over time. This should include KPIs for specific industries alongside concise guidance on key material sustainability issues for each sector which should be disclosed by all as a minimum. For example, human rights should be covered in accordance with ISO 26000 guidance. The extractive industry should publish online details of payments to foreign governments so the Governments could be held to account. One respondent felt that the current approach was an obstacle to quality reporting which needed more specific and detailed regulations which need not prevent the company from telling its individual story.

[5] Extensible business reporting language

Business Review

Consultation question

<u>Question 9</u>: Looking at an Operating & Financial Review and the existing business review (see Annex D), do you see value in reinstating elements of an OFR and if so what would they be? In particular, would a statutory reporting standard help to improve the quality of reporting?

51. Views were again strongly divergent here. The majority of **companies and business representatives** saw no benefit in reinstating an OFR. The business review substantially covered the same issues as the original OFR and the framework was set at the right level giving the necessary flexibility for companies to report in light of their specific circumstances and to meet the needs of their investors. One respondent noted that prospectuses were required to include an OFR but there was little evidence this was valued by investors. If change was to be made, it would be important to determine first the purpose and scope of reporting.

52. On a reporting standard**,** while some saw value in updating the Accounting Standards Board (ASB) guidance, only two saw any merit in making this statutory with one supporting standard reporting formats. The majority considered that making this statutory would add to the regulatory burden, was likely to lead to more boilerplate reporting and would not achieve any improvements in quality. Some noted that the current regime still needed time to bed down; best practice was more likely to emerge from market pressure and possibly guidance from BIS and/or FRC – one respondent cited the example of companies voluntarily providing a reconciliation on Net Debt in response to investors' preferences. On audit, some voiced concern that reinstating the original audit standard would add to costs and could stifle reporting.

53. **Investor and investor bodies'** views were mixed. Most felt the business review had generated useful data but, as noted elsewhere in this summary, quality of disclosure varied with inadequate forward looking and strategic sustainability information. Some investors saw no advantage in reintroducing the OFR while some saw the OFR as more thorough going and strategically

orientated providing greater potential to assess a company's prospects.

54. On a statutory reporting standard investor views varied again. On one side, some felt flexibility was necessary to reflect the unique nature of the business and a statutory standard would encourage a compliance approach. On the other side, a standard applied on a comply or explain basis could expand on issues covered by the regulations and might help to improve quality at the tail end of reporters. Some suggested that the existing non statutory guidance could be revised including new guidance from the International Accounting Standards Board (IASB). * A market led approach was favoured by some but the development of the role of FRRP would be welcomed to take action on companies who did not comply with existing requirements.

55. On audit investor opinion was divided. There was seen to be value in independent assurance of sustainability and carbon reporting and a view that verification should be an outcome of the consultation. Others cautioned that more thought should be given to what an appropriate framework might be to provide assurance while ensuring a proportionate approach.

56. Among **lawyer/accountants and other respondents**, some supported the view that an OFR should not be reintroduced given the current requirements were still quite new. Several however agreed that there could be some amendment of the existing regulations, for example, to disclose objectives and strategies and business model or other specific issues such as management of employees or greenhouse gas emissions. On standards, again there was a range of views with some agreeing that an update of existing guidance might be useful but seeing little added value in making guidance statutory which risked more boilerplate reporting. Others however saw value in a statutory standard and one cited a study [6] indicating that a rules based approach generally improved disclosures. One noted this would help to deal with reporting beyond FTSE100 where disclosures on issues such as health and safety management were poor. The audit question needed further consideration but one raised a doubt on auditor competence on issues such as carbon reporting.

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[6] The Management Commentary: comparing narrative outcomes from alternative regulatory regimes. V Beattie, B McInnes & J Pierpoint

57. **NGOs and Trade unions** all supported a statutory reporting standard with a focus on strategic factors and how environmental and social factors affect them. This should also make clear what constituted adequate social and environmental reporting to ensure reporting to a comparable and agreed standard. This might include future risks and developments for example, existing court cases and regulatory action.

58. All **NGOs and Trade unions** also agreed that independent verification was needed to provide assurance to investors in using the data. It was acknowledged that there could be difficulties in auditing non financial and forward looking data but one option would be to at the reporting process and the underlying assumptions. One stakeholder suggested that action could be phased, with a reporting standard introduced and allowed to bed down to be followed by an audit requirement.

Consultation question

Question 10: The business review provisions require quoted companies to report, to the extent necessary, on:

- **main trends and factors likely to affect the future development, performance and position of the company's business**
- **information on environmental matters**
- **information on employees**
- **information on social and community matters**
- **persons with whom the company has essential contractual and other relationships**

i) is this information useful to you? How do you use it?
ii) Could disclosure be improved? If so, how?
iii) Are there key issues which are missing? If so, please explain?

59. This question was largely aimed at users of company reports but there were a range of views from all respondents.

While noting that this was more relevant to investors, **company and business representatives** made a number of points under ii) & iii) Many felt that the existing provisions, in tandem with the Corporate Governance Code , covered the right range of issues. Some industries were working to improve their disclosures on social and environmental matters and this would continue to develop over time but was an iterative process. Additional regulation would not add anything to that process but Board level responsibility for social and environmental issues helped to improve reporting quality. The annual report would not meet all stakeholders' needs on these issues but companies signposted to other sources and engaged in other disclosure initiatives e.g. the Carbon Disclosure Project. On what was missing or could be improved there were a number of observations:

- The provisions were not relevant to investment companies; should the regulation therefore make clear this applied where appropriate only or set limits such as employee or emissions thresholds.
- Health & Safety was not stated though it was implied by employees; marketing could be added.
- The whole front half of the annual report should be in the business review.
- Rather than "information on" the regulations should say "outcomes for engagement with".

60. **Investors and investor bodies** generally saw this element of the business review as providing potentially valuable information which they could use to assess how the company was governed as an indictor of future success and as a basis for dialogue. The range of issues was adequate and there were some concerns about adding requirements. However many felt that, while there had been improvements in standards particularly since the introduction of the Companies Act 2006, disclosures in this area still lacked coherence and relevance. Application of the existing requirements therefore needed to improve but this was best done through dialogue between companies and their owners. While some users would like more detail in addition to business review data, some of this should be covered in other reports and cross referred in the business review. Areas to improve included more effective KPIs, time periods and performance against them, better coverage of main trends and factors affecting future development, a better linkage of principal risks, objectives and strategy driven by the vision and direction of the Board; governance of CSR issues; and how they measured materiality.

61. Elements which might be missing included: Business ethics and how they were applied (the risks from failure to adopt anti corruption measures were likely to increase); capital allocation; employee engagement; merger &acquisitions processes; Directors' training on ESG; biodiversity; conflicts of

interest under Directors' duties.

62. **Lawyer/accountants and other respondents** echoed several of the points made by companies or investors. In particular some considered that reporting was generally high quality and had consistently improved. However progress was still to be made on both "main trends and factors" and environmental and social issues where companies needed to be clear on relevance and how the issues were managed; guidance on what was meant by "to the extent necessary" could help. As mentioned elsewhere the work of the International Integrated Reporting Committee could help in improving standards. Some also felt the regulations struck the right balance between regulation and flexibility and noted that the UK regulations exceeded current EU requirements. A coherent approach to guidance and/or regulation was needed to help companies to focus. Elements which were missing or might need review included: issues relating to reputational risk; the provision on contractual arrangements which was poorly understood and therefore applied; more forward looking data for example on carbon costs and more quantitative info; KPIs for environmental and Health &Safety risks. One respondent suggested that the examples of other jurisdictions, for example, US & Canada could be explored to see if they could be applied in the UK to improve reporting on forward looking information.

63. **NGOs and Trade unions** made a number of specific points not raised by other respondents under this question. Several noted the need for a more precise regulatory framework which set out exactly what was needed on social and environmental matters to help companies and users. Human rights issues should be included explicitly. There was a need for greater rigour and reliability in the information provided, for example, by explaining the assumptions used and some level of verification. The regulations should be extended to require extractive industries to cover country by country and project by project reporting of payments to foreign governments in line with the new US Dodd-Frank Act.

Consultation question

<u>Question 11:</u> Would more guidance be helpful? If so, what form should this take? For example, best practice example, sample Key Performance Indicators, etc?

64. Views diverged significantly on this question between NGOs/trade unions and other categories of respondents.

65. One view voiced by respondents from **company, investor and lawyer/accountants/other** groups was that there was already enough, at times conflicting, guidance and it would not be helpful to add to this. Good practice was already highlighted in FRRP/ASB reports* and there were plenty of advisory and professional bodies able to advise on good practice.

66. Some investors were concerned that additional guidance might be unhelpful given the number of companies across a variety of sectors and the risk that directors may feel constrained by such guidance which would not encourage the more meaningful and individual approach. Investors should provide their own feedback – as owners they had a key role to play in encouraging best practice and acting where it was not followed (see also Qs 5 &13).

67. Some however felt there could be scope for non statutory guidance, for example, on the minimum acceptable standards. Many suggested that the existing ASB reporting statement could be revisited and refreshed and could become an authoritative single source of guidance with other guidance consolidated here or signposted. Some noted particular gaps in the guidance, for example, on long term environmental impacts on Health and safety and employee matters which could be addressed either via new guidance or referral to existing guidance (possibly annexed to the ASB guidance). Guidance which might be helpful included:

- Company led sector guidelines which could be developed through discussion with shareholders. Companies might be encouraged to benchmark their report against such guidelines which could be monitored by sector bodies.
- Guidance from Government on the aim of the business review to encourage reporting in the spirit of the regulation.
- Examples of best practice in action, for example, an integrated report.
- Advice on the reporting process, for example, who should be involved in preparing reports; the link between board discussions and disclosure; elaboration of guidance already issued by FRRP/ASB.

68. There was a need to promote the right environment for innovation and experimentation while also providing some challenge where companies consistently fell short of expectation. To ensure guidance did not encourage a tick box approach, one respondent suggested a check list could be used which made directors reflect on the information and its presentation.

69. Views were divided on KPIs with some feeling strongly that these should be determined by directors and sample KPIs were more likely to lead to boilerplate reporting. Conversely others felt there could be some value in guidance here, for example, limiting the number to those which really were “key”, linked to executive remuneration, based on the industry sector or following existing frameworks, for example, the Global Reporting Initiative or DVFA/EFFAS (European Federation of Financial Analysts Societies) KPIs for ESG.

70. Some noted again that there should be better linkage between the front and back of the report and the work of the International Integrated Reporting Committee should be supported to that end.

71. NGOs and Trade unions agreed that guidance might be helpful but this should be alongside a statutory reporting standard (see Q10) which was essential to set minimum standards to address current deficiencies. Some suggested particular guidance which should be promoted, for example, the Carbon Disclosure Project guidance and DEFRA guidance on greenhouse gas emissions. Guidance should set out non financial KPIs to ensure meaningful and comparable reporting: this should cover key specified social and environmental matters, general principles to follow such as forward looking, strategic, balanced and relevant together with an appropriate format. Practical guidance for directors on preparing an OFR would also be useful which could draw on guidance prepared for the original OFR. One suggested a review of materiality guidance as well as considering the applicability of King III guidelines as used in South Africa.

Consultation question

<u>Question 12:</u> Should there be a shareholder's advisory vote on the Business Review?

	Yes	**No**	**Not sure/further exploration**	**No comment**	**Total**
Companies	0	10	0	0	10
Business representative bodies	1	8	0	1	10
investors	5	4	1	1	11
Investor representative bodies	4	2	0	1	7
NGO & TUs	7	2	0	4	13
Lawyers & accountants	1	8	3	1	13
Other	2	8	2	13	25
Total	**20**	**42**	**6**	**21**	**89**

72. Within these figures there are various caveats. For example, some respondents noted this would be useful if it was associated specifically with sustainability information rather than on the business review – two investor respondents in particular supported that formulation and not a vote on the business review. One respondent was looking for a vote if it was likely to deal with Health and safety issues. Two investor respondents were looking for a vote on a voluntary basis at least in the first instance. The strength of view varied also – some NGOs in favour noted that it might be useful while one union body was strongly supportive. No companies were in favour.

73. The arguments in favour and against were broadly as follows:

In favour

- Would send a strong signal to companies and investors on the importance of the issues covered in the business review ie strategy and management of key risks including environmental, social and governance matters.
- Would ensure board level responsibility for the business review and drive the agenda including on environmental, social and governance issues from the top.
- Would enable shareholders to challenge without voting down the whole report and accounts.
- Could improve engagement with companies by providing a focus and encouraging shareholders to discuss their position in advance of a vote.
- Potential difficulties with a vote on the business review as a whole might be resolved by an alternative approach such as a vote on the sustainability report or environmental, social and governance aspects of the annual report.
- The vote need not be statutory to allow companies to lead by example first.

Arguments Against

74. While there was a need for effective monitoring and feedback to companies on their reports, a vote could be a blunt tool to do so and could undermine the focus on better engagement.

75. There was already a vote on the annual report and accounts which together with the new requirement for an annual vote on election of directors provided shareholders with the opportunity to hold directors to account. A vote would add to an already crowded AGM agenda to little purpose. Equally, if there were no consequences to an adverse vote, it could be seen as meaningless.

76. Unlike the remuneration report which was focused, the business review covered a wide range of information which would make it difficult to know how to interpret a vote – would it be perceived as a vote of confidence? For the investor, a vote for the review could be seen to endorse it all even if they were not happy with specific aspects while a vote against would not make

clear which elements were of concern. Equally what would it mean to have a vote against the business review but a vote for the annual report and accounts? Could there be unintended consequences if the proportion of short term shareholders encouraged short term horizons in reporting rather than the desired long term approach? The vote could encourage more risk aversion on the part of directors leading to poorer quality disclosure and thus run counter to the overriding objective.

Possible Alternatives

77. Some were not convinced of the value of the vote but saw some merit in looking at this in more detail and exploring alternative options for example a focus on specific issues in the report.

78. Alongside the vote, the system for filing shareholder resolutions which was onerous and complex should be looked at to improve accountability

79. If we were looking for shareholders to change company behaviour could investor representative bodies assess corporate reporting as part of their oversight procedures?

Consultation question

Question 13: Are there non-regulatory solutions to increasing quality through better guidance or publicising excellence in business reports? If so, what?

80. Responses to this question overlapped significantly with views expressed at Q11. The responses here have been combined across all groups as there was significant common ground but with any notable differences highlighted.

81. Many noted that there were already various non regulatory initiatives such as studies of reporting practice, sector specific guidance, awards and indices to encourage best practice and publicise excellence. While respondents across all groups saw a place for awards in promoting best practice and encouraging improvements - “name and fame” rather than “name and shame”, several felt these had limited impact as they were only likely to incentivise the top end of reporters and would not deal with “laggards”. Some suggested scope for these initiatives to highlight poor as well as best practice.

Evidence to support the view that better reporting led to better performance and value creation would be the strongest incentive to improve standards. There was not much support for an expert panel to rank reports which was considered unlikely to add value. However one stakeholder suggested surveys, league tables or kite marks might be effective.

82. Shareholder pressure was likely to be more effective than awards in improving relevance and quality. A voluntary advisory vote coupled with more effective engagement was suggested.

83. **NGOs and Trade unions** expressed concern that non regulatory means could only be effective alongside regulatory measures to address current deficiencies by setting a minimum standard which was enforced. For example, while most FTSE350 companies now covered carbon in their reports, some still chose not to. One academic respondent also noted evidence indicating that detailed guidance did elicit more information and non mandatory solutions would have limited impact. [7]

84. Most respondents commented again here on the role of the FRC and in particular the FRRP which was considered to exert considerable influence. There was scope for FRRP to extend its role by highlighting good practice, issuing guidance based on reviews of company reports, ranking performance to encourage companies at the bottom to improve.

85. The potential of electronic communication was also mentioned as a means of improving reporting and is covered in more detail at Q8 above.

[7] The Management Commentary: comparing narrative outcomes from alternative regulatory regimes. V Beattie, B McInnes & J Pierpoint

Directors' Remuneration Report

Consultation question

Question 14: Do the current disclosure requirements provide clear and usable information about:

- **the total remuneration paid to directors, and how this is made up;**
- **the performance criteria for payments to directors, and how these relate to the company's strategic objectives;**
- **company performance against these criteria, so that there is a demonstrable link between pay and performance.;**
- **the process by which directors' remuneration is decided?**

86. The majority view was that whilst the Directors' Remuneration Report Regulations (DRRR) promoted full disclosure and the quality of reporting had slowly improved, many respondents remained unimpressed with the quality of reporting. Many of the reports themselves were over-long, over-complicated and unclear – particularly in dealing with the link between remuneration and company performance.

87. Most respondents wanted more clarity on the link with company performance, which could be achieved through further disclosure about performance criteria and targets (and the rationale for them), strategy, and KPIs and the link between the different elements of remuneration and the achievement of company objectives.

88. Other issues raised were the need for companies to report total remuneration paid to directors as a single figure sum and the need for the overlapping requirements between company law and the Listing Rules to be tidied up.

89. In general it was accepted that where specific information was required, this could be best achieved through legislation, but where clarity of explanation was needed, this would be better achieved through improved best practice guidance. Some suggested that the report should be shorter with

more detailed disclosure filed with the regulator or put on the company's website

90. There was recognition among **company and business representatives** that the UK's statutory disclosure requirements on directors' remuneration were detailed and extensive. The majority view was that most reports were unduly lengthy and that the presentation of information was of variable usefulness. One cautioned against further disclosure requirements which had the potential to put the UK at competitive disadvantage by deterring talented directors from joining UK boards. The overall view was that no more disclosure was necessary and that better disclosure would not be delivered through prescriptive legal requirements, but driven by guidance and peer group pressure.

91. Most **Investors and Investor bodies** thought that there was great disparity in the quality of disclosure between companies and in general too much boiler plate. Whilst the specific requirements of the DRRR were comprehensive and in principle sufficient, the interpretation of the requirements resulted in a variety of approaches, not all of which assisted in an informed view of remuneration.

92. There was disagreement about how to achieve better disclosure. Some were not keen on further statutory disclosure requirements and favoured improvement through industry best practice (perhaps through the UK Corporate Governance Code); but a number of suggestions were made for further disclosure through legislation, for example:

- the rationale behind the selection of performance targets and how they connected to the company's long-term strategy;
- performance delivered against the targets that were set;
- remuneration consultants' fees;
- more detail on annual bonuses;
- total remuneration expressed as a single figure for each director.

93. Whilst some **accountants/lawyer respondents** believed that the DRRR had improved transparency and promoted engagement with shareholders, a recurring point was that policy disclosure was largely standardised and did not usually explain link to strategic objectives and any changes in remuneration

policy.

94. A major issue was the disclosure of performance criteria for payments to directors. This remained limited on how bonuses were awarded, and how remuneration was linked to strategic objectives. These were often poorly explained. Other additional issues raised were:

- performance reporting on basis of Total Shareholder Return is not relevant for many companies;
- the need for better explanation of compensation for past directors;
- the remuneration report should explain how shareholder concerns addressed if previous year's report did not receive majority support.

95. It was also suggested that there were overlapping disclosure requirements between company law, accounting and Listing Rules which added unnecessary complexity and should be reconciled.

96. **NGOs/Trade unions and others** expressed concern about appropriate levels of pay. It was suggested that remuneration committees did not consider pay in the rest of the company as recommended by the Corporate Governance Code and disclosure of information about employee pay should be required, such as:

- the ratio of highest director total pay to lowest employee pay in the company;
- the distribution of pay throughout the company as a whole by grade;
- each director’s increase in basic salary for each of the last three years;
- the average pay increase for staff elsewhere in the company for each of the last three years.

97. Again respondents cited the need for better disclosure on the selection of performance criteria and targets for executive remuneration, including better quality information on the rationale behind selected criteria relation to strategic objectives, KPIs and performance targets.

Costs

Consultation question
<u>Question 15:</u> **If you can provide any information on costs associated either with the existing narrative reporting requirements eg preparing your business review or your views on potential costs and benefits in relation to any of the ideas in this consultation, please give details**

98. The **company and business representative respondents** generally made similar points. Several devoted substantial time and resource to the production of the annual report and accounts (a few estimated costs which ranged from around £145k to £1m while another estimated that the production process was detailed involving up to 100 people.) One company which had given a vote on its corporate responsibility reporting estimated the associated costs as £5k with the benefits outweighing these costs. Printing and mailing costs were substantial for those with a wide stakeholder base.

99. Several noted that additional requirements would add to these costs and one felt this could be difficult to justify in business terms if the requirements were to meet wider public interests rather than business needs. There was also concern that adding costs during economic downturn would damage competitiveness while more prescriptive requirements might not achieve the goal of improving the quality of reporting.

100. A couple of business respondents however did not consider the consultation raised any proposals likely to have a significant impact on costs. One noted that better or simplified guidance could help achieve focus on the issues that mattered to companies and their stakeholders. Greater use of online reporting might also help reduce costs.

101. Other respondents were less likely to comment but key points were:

- the costs should be proportionate to the size and complexity of the business

- the average length of reports had increased from 44 pages in 1996 to 100+ pages by 2010 and some agreed that additional or more prescriptive requirements would add costs.
- the biggest costs currently were in ensuring compliance; a reduced or simplified framework would decrease costs and allow companies to focus on critical issues.
- several considered the company should already have the necessary data so improving the quality of reporting should not add significant costs and may have positive benefit outweighing any costs. An assessment of costs had been done for the Government in Denmark*.

Conclusions & next steps

102. The number of studies and other initiatives focusing on corporate reporting suggest that this consultation has been timely. In particular, as many respondents have noted, the International Integrated Reporting Committee was launched at the beginning of the consultation period and is aiming at an internationally accepted reporting model which covers financial and non financial matters. In November the European Commission published an online consultation on non financial reporting by companies. This is due to close on 24 January and we would encourage interested parties to respond to ensure UK views are represented.

103. On the domestic front, on 25 October BIS published a Call for Evidence on a Long Term Focus for Corporate Britain which looks at short-termism, investor engagement, directors' remuneration and the economic case for takeovers. That consultation closes on 14 January 2011 and in light of responses to this consultation on narrative reporting and that Call for Evidence we will be developing policy proposals on the corporate governance agenda by Budget 2011.

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Annex A

List of Respondents

Addison
Aldersgate Group
Amnesty International
Asoociation of Chartered Certified Accontants (ACCA)
Assocation of British Insurers (ABI)
Association of Investment Companies
Aviva Investors
Barclays
Black Sun Plc
British American Tobacco
British Property Federation
British Safety Council
British Standards Institution
BT Group Plc
Business in the Community
CAFOD
Carbon Disclosure Project
Chartered Institute of Management Accountants
Chartered Institute of Personnel and Development
Chartered Management Institute
Church Investors Group
ClientEarth
Communication Workers Union
Confederation of British Industry (CBI)
Deloitte
Elementus Ltd
Environment Agency
Ernst & Young
F&C Management Ltd
FairPensions
Financial Reporting Council (FRC)
GC100
GlaxoSmithKline
Governance for Owners
Grant Thornton

Hammerson Plc
Henderson Global Investors
Hermes
Hundred Group
Institute of Environmental Management & Assessment
Institute of Chartered Accountants in England and Wales (ICAEW)
Institute of Chartered Accountants of Scotland (ICAS)
Institute of Chartered Secretaries and Administrators (ICSA)
Institute of Directors
Institute of Practitioners in Advertising
Institution of Occupational Safety and Health
Investis Limited
Investment Management Association
ITV
KPMG
Law Society
Legal & General Group Plc
Legal & General Investment Management
Local Authority Pension Fund Forum
London School of Business & Finance
Mazars
MM&K Limited
National Association of Pension Funds (NAPF)
Newton Investment Management Limited
Osborne Clarke
Pensions Investment Research Consultants (PIRC)
Portsmouth Business School
PricewaterhouseCoopers (PWC)
Prism Cosec
Publish What You Pay
Quoted Companies Alliance (QCA)
Radley Yeldar
Railpen Investments
Sabien Technology Group Plc
Serco Group Plc
Tax Partners Ltd
Tesco Plc
The City of London Law Society
The Communication Workers Union

The Cooperation Incubator
The Co-operative Asset Management
The Corporate Responsibility (CORE) Coalition
The Investor Relations Society
The Strategic Planning Society & FutureValue
The Virtuous Circle Limited
Tomorrow’s Company
Trades Union Congress (TUC)
Trucost Plc
UK Commission for Employment and Skills
UK Shareholders’ Association
Universities Superannuation Scheme
University of Glasgow Business School
WorkMatters Consulting
WWF

Annex B

List of principal studies or sources cited by respondents or referred to during the consultation

ACCA
Narrative Reporting: Analysts' Perception of its Value and Relevance
http://www.accaglobal.com/pubs/economy/analysis/acca/technical_papers/tech_3.pdf

ACCA & Deloitte
Hitting the notes but what's the tune? An international survey of CFO's views on narrative reporting
http://www.accaglobal.com/pubs/af/narrative/new/hitting_the_notes.pdf

Accounting for Sustainability
Connected Reporting – A practical guide with worked examples
http://www.accountingforsustainability.org/files/pdf/Connected%20Reporting.pdf
Practical Insights – A summary of case studies in embedding and reporting sustainability
http://www.accountingforsustainability.org/files/pdf/Practical%20Insights.pdf
Governance & Collaboration – Establishing an "International Integrated Reporting Committee"
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The Accounting Standards Board (ASB)
Rising to the Challenge -
A Review of Narrative Reporting by UK Listed companies – 2008/9
http://www.frc.org.uk/images/uploaded/documents/Rising%20to%20the%20challenge%20October%202009.pdf

Black Sun
Rethinking Reporting – annual analysis of FTSE100 corporate reporting trends 2009
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http://www.blacksunplc.com/corporate/ideas_insight/index.jsp

Church Investors Group
The Ethics of Executive Remuneration: A Guide for Christian Investors
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Corporate social Responsibility and Reporting in Denmark: Impact of the legal requirements for reporting CSR in the Danish Financial Statements Act
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http://www.icas.org.uk/site/cms/download/AA/Making_Corporate_Reports_Readable.pdf
Voluntary Annual Report Disclosures: What Users Want
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ICSA
Board Performance Evaluation – Review of the annual reports of the FTSE 200 companies
http://www.icsa.org.uk/products-services/icsa-board-evaluation?c=1

Institute of Environmental Management & Assessment
Special Report GHG Management and Reporting
http://www.iema.net/ghgreport

Professor Adrian Henriques, Middlesex University
The reporting of non financial information in annual reports by FTSE 100 companies
http://corporate-responsibility.org/wp/wp-content/uploads/2010/04/Reporting-of-Non-Financial-Information-by-the-FTSE1003.pdf

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V Beattie & K. Pratt
Voluntary Annual Report Disclosures: What Users Want – published by ICAS
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V Beattie & SJ Thomson
Intellectual Capital Reporting: Academic Utopia or Corporate Reality in a Brave New World – published by ICAS
http://www.icas.org.uk/site/cms/contentviewarticle.asp?article=6837

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