Financial Reporting Council

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Dear Jane

The future of narrative reporting

I enclose the FRC's response to the Department's consultation on the future of narrative reporting. This letter highlights our key views.

The consultation focuses on the Business Review and its development by reintroducing some form of the OFR. We support your review of these points, but encourage you to take a wider perspective on the Annual Report as a whole. This Report is the principal way in which directors explain to their shareholders how they have discharged their stewardship responsibilities. We also believe it can and should be the means by which the directors give a view of their vision and strategy for the future development of the business, including their business model and the risks associated with it. In short, it should be the corporate version of a state of the nation address. In reality it has become a confusing compendium of material required for a raft of regulatory and other purposes. Its role and significance has also been called into question by the publication of a plethora of other financial and stakeholder reports, none of which, alone or together, can adequately serve in its place as an authoritative stewardship statement.

Current state of narrative reporting

Much of the material we would like to see in such a forward-looking report is already provided, and in some cases provided well. However, this is not

universally true. Many companies do not adequately explain the business they are in and how they can be profitable. The quality of risk reporting is especially patchy, with too many examples of boilerplate text and a lack of analysis of the specific challenges to the business rather than generic risks that are true for any company.

In addition to our concerns about the content of the Report, we are also concerned about its presentation. In too many reports there is too much clutter for the key messages to be evident to investors and others. In some instances this is as much the result of the piecemeal development over time of the regulatory framework, which has established overlapping requirements. We hope that the opportunity will be taken to consolidate and streamline the regulatory framework.

The answers cannot, however, just lie in new regulation. We hope the consultation will seek innovative ways of encouraging good quality reporting other than just through new regulation or standards. Our experience has shown the difficulty of legislating for the quality of reports: the more detailed the rules, the more boilerplate the text. We need to look for ways to incentivise more companies to follow the example of the best in communicating clearly. Investors and other users have a part to play in this and we need to find a mechanism that will enable them, the real beneficiaries of corporate reporting, to drive change.

Audit considerations

At present the narrative report as a whole, and the Business Review in particular, are not subject to statutory audit. However, auditors are required to state whether in their opinion that information given in the Directors' report is consistent with the financial statements. We believe that you should consider carefully what level of assurance should attach to the Report. As a key element of good governance and the Board's stewardship responsibility, there is a good case for it to be subject to external review. However, a narrative report that incorporates forward-thinking information cannot be audited in the same way as historical accounts and it would be misleading to leave investors with the impression that such a report would be as securely assured as the accounts are by the "true and fair" opinion. We need to consider whether external assurance should be required in relation to the content in narrative reports or just to the quality of the process the directors have gone through to arrive at their conclusions. We must also avoid the risk of directors not reporting openly and auditors not giving any valuable assurance because of their fear of exposing themselves to litigation.

Who are narrative reports for?

There is also the question of who the narrative report is written for. The company is run by the Board on behalf of the shareholders. Company law requires that only matters of material interest to shareholders need to be reported. Any change to this fundamental principle needs very careful thought, particularly at a time when business is looking to the equity market to recapitalise in the face of reduced bank lending.

However, we must also recognize that corporate reporting is evolving and that companies are giving more information to a wider group of stakeholders. The Companies Act 2006 clarified the responsibility of directors to address in the Annual Report environmental, employee, social and community issues to the extent necessary for an understanding of the business. Modern reporting also reflects the fact that in a world of global communications the company's reputation in key markets and its very existence can be threatened by matters which until recently would never have had a significant reputational impact and would not have been material to shareholders.

In these circumstances, directors need to consider carefully the issues that are relevant to a wider range of stakeholders whose views determine the company's reputation. That said, we believe the current directors' duties remain valid and are an appropriate framework for reporting to shareholders and stakeholders. Rather than change the law, we should focus on improving the application of the current framework, particularly in how longer term issues such as sustainability are reported. The role of narrative reporting and the OFR should be considered in this context.

Yours sincerely

Stephen Haddrill
Chief Executive

BIS | Department for Business Innovation & Skills

Consultation response form: The Future of Narrative Reporting

A copy of the consultation available at: http://www.bis.gov.uk/consultations.

Responses to the Consultation by be received by 19 October 2010

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Please tick the box from the following list of options that best describes you:

	Quoted company
	Other company
	Investor or investment manager
	Business representative organisation
	Investor representative organisation
	Non governmental organisation (NGO)
	Trade Union
	Lawyer or accountant
√	**Other (e.g. consultant or private individual) Regulator**

Value of narrative reporting

Question 1: Are company directors providing useful and relevant information on the company's:

i) forward-looking strategy and
ii) principal risks and opportunities?

Comments
Based on the evidence of the work of two of the FRC's operating bodies, the Accounting Standards Board (ASB) and the Financial Reporting Review Panel (FRRP), the picture is a very mixed one. **(i) Forward-looking strategy** A review by the ASB of the 2008 and 2009 narrative reporting of 50 listed companies (published in October 2009 as *Rising to the challenge*, available at http://www.frc.org.uk/asb/press/pub2148.html), found that while not explicitly mentioned in the current Business Review (BR) requirements within the Companies Act (CA) 92% of the sample attempted to outline some objectives or strategies, or both. However, only 48% of the sample went beyond the statement of an objective, eg 'our goal is to grow sales', to articulate their strategy of how they planned to achieve their stated goals. Within the sample, the ASB found that the best reports explained or illustrated how they measure the achievement of strategies, often by linking Key Performance Indicators (KPIs) to strategy. **(ii) Principal risks and opportunities** While the ASB's *Reporting Statement: Operating and Financial Review* makes clear that 'the description of the principal risks and uncertainties should cover both the exposure to negative consequences as well as potential opportunities', the current BR requirements only refer to 'principal risks and uncertainties'. The ASB's review found that the focus of companies was on listing risks, with one company listing 33 and a further eight companies noting 20 or more risks. In our view long lists of risks adds to clutter in annual reports and does not provide useful and relevant information. All of the companies in the sample provided some information on risks. 66% of the companies sampled were technically compliant because they referred to some risks, but in our view needed to make improvements to meet the spirit of the requirements. Too many reports contained generic risks, as well as too little detail to identify the specific matter giving rise to the risk. Best practice reports provided a company-specific explanation of a limited number of risks

that were clearly principal, as well as some context for the risk – is it increasing or decreasing – and some idea of the impact of a risk crystallising.

The above view relating to principal risks has been echoed by the FRRP. The FRRP is responsible for ensuring that the annual reports of public companies and large private companies comply with the requirements of the CA and applicable accounting standards. In the FRRP's Annual Report published in August 2010 (available at http://www.frc.org.uk/frrp/press/pub2349.html), 'some companies disclosed a litany of possible risks that they, or indeed any company, might face without indicating which were the principal risks or saying why they were important to the company.'

Question 2: What are the constraints on companies providing information on these issues?

Comments
We are not in a position to answer this question. However, we note that in relation to the reporting of principal risks the tendency to provide long lists appears to be a particular issue for those companies who are also Foreign Private Issuers registered with the US Securities and Exchange Commission (SEC).

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

Comments
We are not in a position to answer this question, but we would certainly hope that the information provided does reflect what the directors discuss at board meetings, in particular given the stated statutory purpose of the BR.

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

Comments
We are not in a position to answer this question specifically as shareholders, but we believe that if companies do provide good quality information that meets both the spirit and the letter of the BR requirements, then shareholders should have a better basis on which to make to make their assessment of the companies they own.

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?

Comments
We are not in a position to answer this question directly, although we hope that the work undertaken by the ASB and the FRRP will help to encourage both investors to challenge companies where they believe the information provided is deficient, and companies to improve their reporting.

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)?

Comments
We are not in a position to answer this question.

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

Comments
In our view there are two areas to consider: 1. Section 417 (5) final paragraph 2. Clarification of Section 417 (5) (c) **Section 417 (5) final paragraph** The ASB's review found that, along with excessive lists of generic risks, another common source of clutter relates to Corporate Social Responsibility (CSR) reporting. In our view one potential reason for this is the requirement in Section 417 (5) that 'If the review does not contain information of each kind mentioned in paragraphs (b) (i), (ii) and (iii) and (c) (environmental matters, employees and social and community matters), it must state which of those kinds of information it does not contain.' As the ASB report notes 'Social pressure makes it difficult for a company to flag up non-disclosure in any of these areas, with the result that companies disclose all three, regardless of the importance of each to the business.' The CA introduces flexibility by application of a number of the requirements 'to the extent necessary'. If the paragraph noted above was removed, it might

encourage companies to consider which CSR matters do impact long-term sustainability of the business and only report on these in their annual report. In our view, in which we acknowledge the importance of sustainability, detailed explanations of such issues are best dealt with in a separate report.

Clarification of Section 417 (5)(c)
In addition, the requirements could be simplified by clarifying what is meant by 'contractual and other arrangements' in paragraph 417 (5)(c). As Lord Sainsbury stated during a session in the House of Lords in 2006:

> 'This is not a requirement on companies to list their suppliers and customers, or to provide detail about contracts. The provision is about reporting significant relationships, such as with major suppliers or key customers critical to the business…'

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

Comments

As stated in the ASB Reporting Statement: OFR, our view continues to be that '… it is for directors to consider how best to use the framework and structure the OFR …'

Business Review

Question 9: 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?

Comments

Reinstating elements of an OFR
If any changes are made, we would support the addition of an explicit requirement to disclose the company's objectives and strategies to achieve those objectives, plus disclosure of the business model (see below).

As highlighted by the comparison of the OFR and Business Review Provisions provided in Annex D of the Consultation, the requirements for quoted companies under a Business Review are very similar to those under an OFR. In our view the one exception relates to the objective set out in original OFR legislation that an OFR should be 'prepared so as to assist members to assess the strategies adopted by the entity and the potential for those strategies to succeed.' This objective leads to the explicit requirement for companies to

disclosure their objectives, as well as the strategies to achieve their objectives.

Business Models

As highlighted in *Rising to the Challenge*, the ASB recommended that companies should be providing disclosure of their business models. Such a disclosure is now a provision within the latest version of *The UK Corporate Governance Code*, published by the FRC in May 2010 (available at: http://www.frc.org.uk/press/pub2282.html). The FRRP has commented on the challenge it has faced of properly understanding a company's business model in order to assess particular accounting policies and the difficulty in determining business models in the absence of a specific disclosure model.

Statutory reporting standard

While there are still particular areas that challenge companies, such as principal risks, it is clear from the ASB's reviews of narrative reporting that narrative reporting by UK listed companies has continued to improve even without a statutory reporting standard.

The FRC has long believed that the publication of a narrative explanation of a company's development, performance, position and prospects should be encouraged as an important element of best practice corporate reporting. The ASB first produced a statement of best practice in 1993 (updated in 2003). This best practice statement was built on by the ASB in the development of their Reporting Standard: OFR, which was published in May 2005. When the Government decided to remove the statutory requirement on quoted companies to publish OFRs in November 2005, the ASB made limited changes to RS1, to make the language consistent with a voluntary statement of best practice rather than a standard.

The ASB's 2009 review of narrative reporting mentioned previously in this response was a follow up to a review undertaken in 2006. The objective of the 2006 review was to keep the spotlight on narrative reporting and encourage continuing improvement in this area.

The 2009 review had similar aims and found that the best reporters continue to evolve their narrative reporting – in terms of content and communication of that content. *Rising to the challenge* sought to provide pragmatic guidance to those responsible for preparing the narrative element of an annual report. It is encouraging to note that over 50% of those included in the 2009 sample of narrative reports sought further feedback from staff at the ASB.

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?**

Comments

In our view, a discussion of trends and factors is important information as context for understanding the rest of the annual report [for all companies].

As noted in the OFR Reporting Statement, 'The OFR should focus on matters that are relevant to the interests of members.' Reporting on environmental, employee and social and community matters should be provided where these issues '...influence on the performance of the business and its value...'. This is consistent with the current Business Review requirements, which are 'to the extent necessary...'.

Trends and factors

The ASB review found that only 38% of companies provided discussion of trends and factors that we consider compliant with the spirit of the regulations. As there appears to be some confusion as to what 'trends and factors' means, *Rising to the challenge* sought to clarify to what was required. The report noted that best practice companies discussion of both macro environmental and company-specific factors. The information provided was relevant, future-orientated, quantified and supported by evidence.

Environmental matters, employees and social and community matters

As noted in the answer to Question 7, the ASB review found that companies are still finding their way in their CSR reporting. While many shareholders and lenders are increasingly interested in environmental and other social impacts, particularly where they have an impact on the long-term sustainability of the business, the ASB found that only 20% of the sample provided a convincing explanation of why CSR is important to their business. However, 54% of companies were still viewed as being compliant in spirit with the regulations.

Contractual and other arrangements
As noted in the answer to Question 7 this appears to be an area of significant confusion, perhaps in part because the current Business Review requirements do not mention 'relationships'. The ASB found that it was unclear whether over half of the sample specifically addressed the requirement or not. Only 8% of the sample provided a good level of detail on most important relationships, commonly as part of a business model disclosure (see comments in above and in covering letter).

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

Comments

Best practice examples
Best practice examples can be helpful.

As a regulator, we are well aware that companies often request examples of what a particular disclosure looks like. This is a difficult area, as we do not want to encourage boiler-plate reporting or reporting to templates. However, in the most recent report on narrative reporting, we concluded that it would be helpful to point to good examples of reporting in particular areas. Accordingly examples of good practice were mentioned in the ASB's report *Rising to the challenge* report.

Sample Key Performance Indicators (KPIs)
Given the ASB's experience, we would not support the development of sample KPIs.

Documents published by the Government following the decision to remove the statutory requirement for quoted companies to publish an OFR indicated that some investors had concerns that the ASB's Reporting Standard had been 'over engineered'. Staff at the ASB have subsequently learnt that this concern related specifically to the provision of example Key Performance Indicators (KPIs). The ASB's Reporting Standard: OFR, and the revised Reporting Statement: OFR, contain 23 example Key Performance Indicators (KPIs) ranging from return on capital employed through to CO_2 emissions within the Implementation Guidance.

While the Implementation Guidance sought to make clear that the KPIs featured related to specific circumstances, for example average revenue per

customer (ARPU) might be a measure used by a telecoms company, the concern persisted that companies might take the KPIs featured as required KPIs.

Given this experience, we would not want to encourage the development of sample KPIs.

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

Comments

No. The recent changes to the UK Corporate Governance Code, whereby FTSE 350 companies are recommended that directors should be subject to annual re-election, should introduce sufficient accountability.

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

Comments

Yes, there are non-regulatory solutions to increasing the quality of narrative reporting.

Both the ASB and FRRP have sought to encourage improvements in narrative reporting through their various publications, mentioned earlier in this response. In addition, the ASB's *Rising to the challenge* report mentions a number of other organisations that undertake research and champion high quality narrative reporting.

However, we would not support the convening of an expert panel to rank company performance as suggested in paragraph 30 of the consultation document. We believe that the current system, whereby a number of organisations champion high quality narrative reports based on their own research, encourages appropriate debate amongst all those involved in their preparation.

Directors' Remuneration Report

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?**

Comments
Best practice remuneration reports will provide the information set out above. However, remuneration reporting is often an area driven by checklists. As noted in our report *Louder than Words: Principles and actions for making corporate reports less complex and more relevant* (available at http://www.frc.org.uk/publications/pub1995.html), remuneration reporting is prescribed by five different sources of overlapping regulations in the UK. Given this complexity, it isn't surprising that most preparers resort to a checklist to ensure they are compliant. In our view it would be helpful to first seek to co-ordinate and rationalise the existing regulations in this area before adding any further regulations.

Costs

Question 15:
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

Comments
We are not in a position to give you the information on the cost of preparing a narrative reporting in compliance with the business review. However, if the requirements are maintained at a framework level we believe the benefits will out weigh the costs. Much of the information is already available and is provided to users throughout the year in other communication. This is an opportunity for management to bring together all the information in one place and tell a single story that is consistent with the financial statements, all

within the disciplined context of preparing an annual report.

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