FairPensions™
The campaign for **responsible** investment

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Ms Jane Leavens
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Thursday 14 October 2010

Sent via email to jane.leavens@bis.gsi.gov.uk

Dear Ms Leavens,

FairPensions welcomes this opportunity to respond to the consultation *'The future of narrative reporting'*. FairPensions is a registered charity which works to promote Responsible Investment (RI) by pension schemes – focussing on engagement and the responsible exercise of ownership rights. Recent experience, from the financial crisis to BP and Vedanta, has forcefully demonstrated that environmental, social and governance (ESG) risks can become serious financial risks. As a recent report by the UNPRI notes, "environmental costs are becoming increasingly financially material." We work with pension funds, their fund managers and advisors to ensure that these risks are monitored and managed.

We welcome the government's commitment to shareholder empowerment, particularly in the context of encouraging more long-termism in business. If investors are to play their role as responsible owners, supporting economic stability and sustainable value creation, they must be given the right tools. In particular, if investors are expected to integrate ESG risks into business decisions, these issues must be properly integrated into company reporting – and, as far as possible, given the same status as financial information. The Coalition commitment to 'reinstate an Operating and Financial Review to ensure that directors' social and environmental duties have to be covered in company reporting' is therefore key to promoting responsible ownership.

At present, many investors tell us that they cannot assess and act on companies' social and environmental reporting with the same confidence that they would financial information. This is because of weaknesses in:

- **Completeness.** CSR reporting tends not to be strategic or forward-looking, and the business review often deals with environmental and social risks only through boiler-plate statements, or – perhaps worse – by giving a partial or misleading picture.
- **Reliability.** Since the original OFR's requirement for an enhanced audit was dropped, the current business review suffers from a lack of verification which makes it difficult for investors to rely on this information in making business decisions.
- **Enforcement.** According to currently available information, in 2008/09 the FRRP did not take enforcement action against any company for its narrative reporting, despite judging the legal compliance of a number of narrative reports to be doubtful. Referrals to the FRRP by investors and other stakeholders are almost unknown, and resources to deal with such referrals appear to be limited.

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In order to address these problems, we recommend that a new reporting framework must deliver five key things:

1. **A clear standard of objectivity.** Narrative information must be fair, balanced and comprehensive, with investors and regulators able to challenge reports where they are inconsistent with what a reasonable director could be expected to report.

2. **Clarity on how social and environmental risks should be reported**, including the *quality* of information expected (balanced, forward-looking, strategic, robust) as well as an indication of what substantive issues might be relevant**.** This could entail reinstating a statutory reporting standard, clearer regulations, and/or further guidance.

3. In particular, **requirements that the sources and assumptions underlying statements made in narrative reports are disclosed and explained.** This should include KPIs, but also extends to broader judgements about materiality or business strategy. If statements are not contextualised in this way, it is very difficult for report users to make an informed assessment of the company's position and performance.

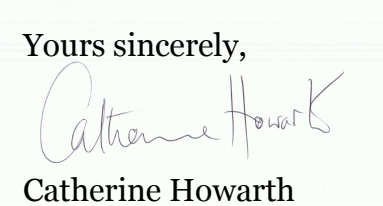
4. **A stronger mandatory audit**, alongside measures to improve the capacity and effectiveness of the audit profession. If the reintroduction of the enhanced audit is felt to be undesirable, it is vital that other measures are devised to address the central problem of verification and reliability.

5. **A powerful, independent, transparent and accountable regulator** – for instance, a strengthened FRRP to sit within the proposed new 'companies regulator'. Reporting requirements will not drive improvements without adequate enforcement, as the experience of the business review demonstrates.

Clearly, addressing these issues will in some cases require regulation, including the revival of some aspects of the original OFR. We therefore hope that the detail of the original Coalition commitment will be honoured in the government's proposals. We would also caution against the assumption that new regulation necessarily means increasing burdens on business. Clearer, tighter, more focussed reporting requirements should mean shorter, simpler reports, with a correspondingly reduced burden on business – not to mention report users. It ought to be possible to balance this with essential measures – such as a verification mechanism – which do entail additional costs, in such a way that the net burden is not increased.

Our full response to the questions for consultation follows. We remain at your disposal to discuss any of the issues raised in further detail.

Yours sincerely,



Catherine Howarth
Chief Executive, FairPensions

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
x	**Non governmental organisation (NGO)**
	Trade Union
	Lawyer or accountant
	Other (e.g. consultant or private individual)

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
There is a widespread sense that company reporting is insufficiently focused – containing large amounts of 'clutter', yet excluding clearly material issues. FairPensions deals primarily with environmental, social and governance (ESG) risks that have a material financial impact on the value of investments. At present, ESG risks and opportunities, and the implications of these for companies' forward-looking strategies, constitute a major gap in directors' reporting. Many companies' narrative reports make only vague, boiler-plate statements to the effect that they take environmental and social issues seriously, rather than integrating specific information on key ESG business risks into their depiction of the company's position and strategy. This is well-illustrated by the environmental NGO ClientEarth's recent referral of Rio Tinto's 2008 annual report to the Financial Reporting Review Panel (FRRP). In this case, the company makes general positive statements about the importance of environmental and social responsibility, but fails to mention numerous specific material issues with strategic implications, including the decision of a major shareholder to divest on environmental grounds, and the reputational and litigation risks associated with specific mining projects. This approach, which is typical of current narrative reports, would clearly not be countenanced for strictly financial information. Most companies do not feel that they need to provide consistent, robust and properly contextualised information about environmental and social risks in the same way that they do for financial information. For instance, in its 2009 Annual Report, BP relied on the International Energy Agency's 'reference scenario' - projecting a 40% increase in world energy demand between 2007 and 2030, with fossil fuels satisfying 80% of that demand - to justify the company's strategy of pursuing riskier 'unconventional' sources of fossil fuel, such as oil sands. It was not made clear that these projections have been devised by the IEA purely as a baseline against which to consider the effects of climate policy: the projections assume no government action to tackle climate change, and a consequent catastrophic temperature rise of up to 6℃. This scenario is not only extremely unlikely, but also has major implications for BP's business, which are not discussed in the report. This clearly constitutes a failure to provide shareholders with useful and relevant information on the company's forward-looking strategy and risk exposure. This narrative was also directly inconsistent with that given by BP's sustainability reporting, which stressed the company's commitment to tackling climate change – and this inconsistency was not made clear to shareholders. As this example illustrates, environmental and social issues are all too often siloed into backward-looking CSR or sustainability reports, wholly disconnected from the business review – which often misrepresents or ignores

material ESG risks.

In a recent analysis commissioned by the Corporate Responsibility Coalition, BP and Rio Tinto were among the best-performing companies in the FTSE 100 for non-financial reporting. Given the significant gaps in reporting discussed above, this is perhaps cause to question the consultation's aim to 'drive up the quality of narrative reporting to the level of the best'. There is a need seriously to consider the possibility that even current best practice may fall short of the quality of information investors need.

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

Comments

One constraint on driving up reporting standards is a lack of clarity in the existing regulatory regime, and a lack of guidance as to what constitutes adequate reporting under the Companies Act 2006. Further guidance would help companies to focus on providing the information that is relevant and useful for investors, and therefore has the potential to reduce the burden associated with reporting, rather than increase it.

Lack of enforcement of the existing business review requirements is also a problem. The FRRP does not have sufficient resources to oversee all, or even most, company reporting. In addition, in those cases where the regulator does take action on inadequate reporting, the process involved is far from transparent. This means there is no equivalent of case law that might clarify and refine companies' (and investors') understanding of what is required, and thereby in some measure compensate for the lack of statutory guidance.

Clearly, quantifying the materiality of environmental and social risks is a challenge. However, there is no reason to think the accountancy profession is not capable of rising to this challenge. Significant work is already underway, from the recently-formed International Integrated Reporting Committee to the work of the Scottish and English accountancy bodies. In our view, the role of government is to support and encourage the development of such thinking, including through an improved statutory reporting framework.

Furthermore, our experiences do not support the idea that these difficulties are the only, or even the primary, constraint on improved reporting. Even when it comes to environmental risks that are obviously quantifiable – such as carbon emissions – company reporting at present often falls short. Moreover, narrative reports should by their nature be capable of highlighting environmental and social issues that clearly constitute financial risks to the business, even where the precise scale of that risk is difficult to quantify. In the examples discussed above, company reports clearly failed to do this.

Arguably, lack of investor demand is itself a constraint. Paradoxically, while many investors cite poor information as a barrier to greater engagement, companies often respond that their investors are not demanding better information. In our view, a central part of the government’s role in this review must be to help break this impasse. It is therefore encouraging that this consultation has been placed in the context of the need to ensure that

investors take their ownership responsibilities seriously. The new reporting regime must therefore not only reflect what investors say they want, but send signals to the investment community itself about the sort of information it should be engaging with in order to protect long-term value for both companies and ultimate asset owners.

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

Comments
No comment.

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

Comments
In our experience, information provided is often inadequate for this purpose. Indeed, much shareholder engagement is directed at pressing for the disclosure of information that should be reported as a matter of course, as a prerequisite for assessing and engaging on strategy and risks. For instance, earlier this year FairPensions was involved in the co-filing of shareholder resolutions which saw investors pressing BP and Shell for further disclosures about the financial risks associated with their oil sands projects in Alberta, Canada. Significant disclosures were made by both companies as a result of this process, including their assumed carbon price – a prime example of the sort of information that should be automatically made available to enable investors to assess exposure to environmental risk. Many investors also say privately that they find companies' environmental and social reporting of very little use in making business decisions – because it is not subject to the same standard of verification as financial information, and because it is not strategic and forward-looking. Such reporting can sometimes seem more like a public relations exercise than a balanced overview of the business, presenting an inappropriately rosy picture that glosses over key strategic risks (see response to Q1). In FairPensions' most recent survey of fund managers, around two-thirds of respondents cited poor-quality data on GHG emissions as a barrier to greater integration of climate risks into investment decision-making, and 89% said they would welcome legal requirements on their investee companies to report their emissions. If we are to rely on the pursuit of 'enlightened shareholder value' to ensure companies behave in a responsible and sustainable way, then company reporting must facilitate this – focussing on material environmental and social risks in a way that allows investors to price those risks into their decision-making.

<u>Question 5</u>: 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
As discussed in response to Q4 above, we have in the past worked with institutional investors to challenge inadequate disclosures through the shareholder resolution process. Although this has proved partially successful, it is an imperfect and costly mechanism. The procedures for filing shareholder resolutions are onerous and complex; this may be one of the reasons why shareholder resolutions are much less common in the UK than in the US, and tend to be viewed as a tactic of last resort. We have already submitted information to the Department on some ambiguities in the law regarding the level of information that must be provided by resolution filers. Clarification of these ambiguities would be helpful.

However, challenging inadequate information should not only be left to shareholders – who may not always be in a position to 'know what they do not know'. Where companies are not meeting their legal obligations to report in a comprehensive and balanced way – which we believe is often the case even under the current regulations – the regulator should step in. A stronger, more transparent and accountable regulator is therefore an essential part of a more effective reporting framework. In particular:

- A more proactive and transparent enforcement approach would help build greater clarity about what constitutes adequate reporting and what does not
- A stronger obligation to consider and act on representations made to the regulator, both by investors and by civil society, would be helpful. In our view, there will always be a role for the latter, since investors may not always want to pursue a complaint due to a desire to avoid jeopardising relations with the company concerned.

We recognise that such an approach would require greater resources than are currently available to the FRRP. This issue merits consideration as part of HM Treasury's proposals for reform of financial regulation, and in any future consideration by BIS of a new 'companies regulator'.

In this regard it would also be helpful to confirm that the Companies Act requirement for the business review to be "fair, balanced and comprehensive" is an objective standard. Although this appears the only reasonable interpretation of the Act's provisions, there seems to be some suggestion that the business review should be nothing more than a chance for the directors to give their subjective view of the business. However, if a report omits information of such significance that no reasonable director could have considered it unnecessary to include, it should be possible to challenge the report as a breach of the requirements.

<u>Question 6:</u> 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

Many investors privately say that they do not use corporate social responsibility reports, since they focus on retrospective reporting of peripheral projects with little or no relevance to the company's core business and key material ESG risks.

Currently many institutional investors rely on 'behind closed doors' engagements to understand the social and environmental risks of investee companies and assess how effectively they are being managed. Whilst we strongly encourage shareholder engagements with companies, we do not believe they are a substitute for the provision of high quality narrative reporting on ESG risks which is made available to the market as a whole.

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

Comments
More robust reporting requirements need not mean more reporting, or greater burdens on businesses. Indeed the reverse may be true: one of the problems with social and environmental reporting at present is the proliferation of lengthy reports of little use to investors, in which key strategic issues are either masked, or ignored entirely. In this regard, we would caution against the assumption that more detailed or 'prescriptive' regulations necessarily equate to more complex or burdensome requirements. Greater legislative clarity on the kind of information that must be provided could well result in shorter, more focussed and concise reports, thus reducing the burden both on companies in producing them, and on investors in using them. Please see also our response to Q13.

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

Comments
Comparability is key to the usefulness of reporting for investors making business decisions. There is certainly scope for information to be arranged in a way that makes comparison easier. Guidance might be helpful here – for instance, this could include templates specifying certain key information that should be included in summary reports in a standard comparable format, rather than buried in extended documents.

Business Review

<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?

Comments

We see value in reinstating two key elements of an OFR: an enhanced audit and a statutory reporting standard. This would address key current deficiencies in both the substance and quality of information provided in narrative reports.

<u>The enhanced audit</u>
In our experience, one of the key reasons investors do not make use of narrative reporting is lack of verifiability. Indeed, we would argue that this is the single most important deficiency that a new reporting regime must address. At present, the FRRP does not have anything approaching the capacity to verify all company reports. In the absence of regulatory enforcement, the only solution that has yet been suggested is the enhanced audit requirement.

We are aware that confidence in the independence and competence of the audit profession is low in the wake of the financial crisis. However, nobody is seriously suggesting the abolition of financial audit as a consequence of this. Rather, regulators and industry bodies are working to tackle these problems – for instance, in the work of the FRC and FSA on provision of non-audit services to audit clients. To seek solutions, rather than to dismiss the value of audit altogether, must be the correct response to recent events.

If investors are to be expected to price in environmental and social issues, information on these issues must be treated in the same way as financial information. Again, we recognise the particular difficulties posed by auditing non-financial information, but we do not believe these are insurmountable, and are involved in ongoing work aimed at tackling some of these difficulties. For instance, it has been pointed out that forward-looking information is inherently more difficult to verify – but it ought to be possible to verify that projections and strategic statements are based on reasonable and transparent assumptions. The BP example given in response to Q1 is instructive in this respect. Another possible alternative would be to audit the *process* a firm has undertaken in writing its business review, although such a requirement would need to be clearly focussed on the substantive question of whether due diligence was exercised, rather than on specific procedural steps which could simply become a box-ticking exercise.

The role of government is to encourage the market for new thinking in this area, rather than to await its spontaneous development. If enhanced audit requirements were introduced, the profession would rapidly respond by developing tools and expertise. In the absence of such requirements, it is hardly surprising that they remain at an early stage.

If the government concludes that it is not practicable or desirable to reintroduce the enhanced audit, it is imperative that it formulates other

proposals to improve the reliability of narrative reporting – such as, for instance, a significantly strengthened enforcement regime. Failure to address the question of verifiability at all would frustrate the purpose of this review.

Statutory reporting standard

We support the introduction of a reporting standard setting out in more detail the content and quality of information that directors must provide. In particular, the government's stated aim to "ensure that directors' social and environmental duties have to be covered in company reporting" would seem to require further statutory clarification as to what constitutes adequate environmental and social reporting. There is a particular need to clarify the nature and quality of information to be provided: for instance, that information must be forward-looking and strategic, that the assumptions underlying key statements should be disclosed, and that all relevant risks should be covered.

However, we do have some concerns that the wording of ASB1 also frustrated this objective – in particular, by leaving key issues such as the level of detail to be disclosed to the discretion of directors. If a statutory reporting standard is to be reintroduced, it must be robust enough to meet the government's objectives.

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

Please see our answers to Q1 and Q9.

Disclosure could be improved by treating environmental and social matters more comprehensively - providing a balanced and honest assessment of key strategic risks, rather than generic reassurances that the company takes sustainability seriously. It could also be improved by greater rigour and reliability – both internally, by disclosing the assumptions underlying key figures and statements, and externally, through some form of audit or verification process.

These improvements could be achieved by revised regulations, guidance and/or reporting standards clarifying the nature and extent of the information to be provided (see Q9 above); and by government, regulators and investors sending strong signals to companies about the levels of reporting they expect.

<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?

Comments
Yes. Please see our answers to Q2, Q8 and Q9. A best practice example would be helpful, but given the deficiencies in current reporting practices, it will be more important to set out *minimum* standards than 'best practice' standards. It might therefore be helpful to provide examples of reporting that would *not* be acceptable and to explain why. Of course, the role of guidance will depend partly on whether a statutory reporting standard is reintroduced. However, we would suggest that some guidance is needed on: • General principles of environmental and social reporting: e.g. that it must be forward-looking, strategic, balanced and relevant to the company's core business • Presentation of key information: e.g. a sample or template for presenting summary information in a concise and comparable way • What environmental and social issues might be relevant to the business, and how. This need not undermine the flexibility for different sectors and types of business to report in a way that is appropriate to them: for instance, it could take the form of a list of factors that might, inter alia, be relevant, along with practical examples of when and how these risks should be reported. ClientEarth's publication *'Environmental and social transparency under the Companies Act 2006: Digging Deeper'* provides an interesting model.

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

Comments
Yes. This would send a strong signal (both to companies and to investors) about the importance of shareholder scrutiny of the directors' strategy and risk management, and the role of the Business Review in facilitating this – as well as providing a practical forum for such scrutiny to take place. It could also avoid the need for investors to vote down an entire report and accounts because of concerns about ESG risks. If it is felt that the Business Review is insufficiently focussed on ESG issues to fulfil this function, there may be merit in exploring alternative ways to give shareholders the opportunity to vote separately on these issues.

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

Comments
We agree that non-regulatory initiatives for driving up reporting standards should be explored. However, they must be considered alongside regulatory solutions, and not as a substitute for them. The key deficiencies in the current framework – such as lack of verification and enforcement – cannot be resolved without new regulation. The wording of the coalition commitment – 'to reinstate an Operating and Financial Review' – suggests that the government concurs with this approach, since clearly this requires regulatory change. We note the statement by BIS that "regulations... to address systemic financial risk will be excluded from the One-in, One-out system" (5 Aug 2010). We also note Edward Davey's recent remarks to the Association of British Insurers that "[the] issues [raised in this consultation] – promoting strong boards and engaged shareholders – are particularly important when considered in the context of the financial crisis. After all, the failings of the financial institutions, their management and owners, were an important factor in bringing about the crisis." Given the importance attached to shareholder empowerment by both Vince Cable and Edward Davey, and its important role in reducing systemic financial risk, we would hope and expect that the proposals arising from this consultation will not be subject to the requirements of the one-in, one-out system. Having said this, we would reiterate the point made in response to Q7: a clearer and more focussed reporting regime has the potential to *reduce* the regulatory burden on business. Non-regulatory initiatives clearly also have a role to play. Awards may not be the most effective solution, since they only serve to reward best practice and can become an exercise in self-congratulation. They are unlikely to have much impact on laggards, and do not assist with highlighting whether (as discussed in our response to Q1) even the best companies are falling short of what might be expected. Two more effective solutions might be: • **Surveys or league tables.** Unlike awards, this would help to monitor and publicise the overall quality of reports, measure improvements in standards, and identify leaders *and* laggards – thereby providing reputational incentives for improvement. • **Kitemarks.** Providing that the minimum standards to be met were sufficiently rigorous, this could be an important mechanism both for incentivising improvements, and for helping market participants to make decisions and to assess the reliability of the information they use. Voluntary initiatives aimed at investors, such as the FRC's Stewardship Code, also have a role to play in making it clear that demanding high standards of reporting is part and parcel of engagement and stewardship.

Directors' Remuneration Report

<u>Question 14:</u> 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
Transparency on remuneration is vital to ensuring that directors' incentives are aligned with the long-term interests of the company, its members and the wider economy. There is a need to consider not only whether existing disclosure requirements are adequate, but whether they are being properly applied in practice. For instance, at present, many companies do not apply the requirement in the Corporate Governance Code to take account of pay and conditions elsewhere in the company in their remuneration report. We would also support moves to encourage both greater use of sustainability KPIs in remuneration, and greater transparency in the way those KPIs are used, to enable investors to judge whether they reflect real improvements in performance.

Costs

<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

Comments
In our view, improvements to the reporting framework need not impose additional costs on business, since if successful they would produce more streamlined and focussed reporting. Better reporting would also significantly reduce costs for responsible investors, who at present often expend considerable resources to extract relevant and useful information from their investee companies. In the few cases where additional cost to business is inevitable – such as the enhanced audit – it is important to consider the wider context of costs and benefits (as set out by BIS in its news release of 5 Aug 2010). Experience, from the financial crisis to the Gulf of Mexico oil spill, forcibly demonstrates

that the costs of poor ESG risk management to companies, their shareholders and the wider economy can be catastrophic. Almost by definition, it is difficult to put a figure on the expected benefits of improved reporting and better scrutiny by investors – but it is crucial that this does not lead to those benefits being discounted. Indeed, one of the key lessons of the financial crisis is that we have a tendency to mis-price risk and to underestimate the costs of exceptional but catastrophic events – and that we do so at our peril.

If the government takes the view – as we do – that the benefits of companies providing verifiable narrative information to their investors outweigh the costs, then the key decision is whether these costs should be borne by business (e.g. through the enhanced audit), by government (e.g. through better enforcement), by some combination of the two, or in some other way.

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