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The Future of Narrative Reporting – A Consultation

Dear Ms. Leavens,

Thank you for giving the Institute of Directors (IoD) the opportunity to comment on your consultation document, published in August 2010. Issues surrounding corporate governance are of considerable interest to the IoD and its membership. We are therefore pleased to present our views on your paper.

About the IoD

Founded in 1903, and granted a Royal charter in 1906, the IoD is an independent, non-party political organisation of 45,000 individual members. Its aim is to serve, support, represent and set standards for directors to enable them to fulfil their leadership responsibilities in creating wealth for the benefit of business and society as a whole. The membership is drawn from right across the business spectrum. 92% of FTSE 100 companies have IoD members on their boards, but the majority of members, some 70%, comprise directors of small and medium-sized enterprises, ranging from long-established businesses to start-up companies.

General comments

The IoD supports the Government's objective of improving the quality of narrative reporting. Audited financial statements provide only a partial snapshot of a company's prospects. The annual report should go beyond the provision of financial information, and tell the story of the business in an easily understandable format.

The overall quality of narrative reporting has improved in recent years. However, there is no room for complacency. Many non-financial disclosures remain relatively 'boiler plate' in nature, and could do more to assist investors and other external stakeholders in their monitoring of companies.

However, whilst it is viable for regulation to define a standardised format for the presentation of financial information, this is more problematic in respect of narrative reporting. The value of narrative disclosure is highly subjective and difficult for auditors or regulators to standardise. Consequently, the detailed format and content of narrative reporting for each company is best determined through an active dialogue between the company, its shareholders and other stakeholders.

The current regulatory framework provides a satisfactory basis for narrative reporting. Since October 2007, UK quoted companies have been required to comply with the enhanced reporting requirements of section 417(5) of the Companies Act 2006. This includes a requirement to disclose information about environmental matters, the company's employees, and social and community issues.

Section 417 also requires all companies (other than those falling within the small company regime) to publish a Business Review containing a fair review of the company's business and a description of the principle risks and uncertainties facing the company. The review must contain detail 'to the extent necessary' for an understanding of the development, performance or position of the company's business.

In addition, the latest version of the UK Corporate Governance Code recommends that directors should include in the annual report 'an explanation of the basis on which the company generates or preserves value over the longer term (the business model) and the strategy for delivering the objectives of the company' (provision C.1.2).

Companies may also voluntarily choose to publish an Operating and Financial Review based on the principles defined in the Accounting Standards Board's 2006 Reporting Statement: 'The Operating and Financial Review'.

We are not convinced that improvements in narrative reporting can be achieved by significant additions to the above regulatory framework. A more prescriptive approach would inevitably lead to a greater volume of unhelpful boiler plate disclosures designed to fulfil regulatory requirements. It would also increase the role of the lawyers in crafting narrative disclosures. This would reduce the overall quality of narrative reporting.

Furthermore, we are not persuaded of the merits of current government proposals regarding the reintroduction of the statutory Operating and Financial Review.

Many larger quoted companies already fulfil most of the OFR requirements within their existing Business Reviews. The main difference between the OFR and the existing regime would be the need for narrative reports to be audited.

However, a statutory requirement for an audited OFR would not necessarily improve the quality of narrative reporting. Although auditors can verify the accuracy of factual information contained within narrative reports, they are not in a position to ensure that it will be meaningful to external stakeholders.

Furthermore, the requirement to adhere to a statutory template would reduce the flexibility of companies to tailor their narrative reporting to their individual circumstances. It would also increase their auditing costs.

In our view, the value of improved narrative reporting would be better embedded through appropriate director training and professional development programmes. As part of their induction and ongoing development, directors should explore ways of improving their communication and engagement with external stakeholders, including through narrative reporting. This is likely to be a more productive means of promoting improved narrative reporting standards than the introduction of new regulation.

We also note that the Financial Reporting Review Panel (FRRP) has recently extended its scope to include reviews of narrative disclosures in its surveys of company accounts. We welcome this initiative, as it provides an external incentive for companies to improve their narrative reporting standards.

Responses to specific questions

1. Are company directors providing useful and relevant information on the company's:
i) forward-looking strategy and
ii) principal risks and uncertainties?

The results of recent surveys undertaken by the Accounting Standards Board (Rising to the Challenge) and Grant Thornton (FTSE 350 Corporate Governance Review) indicate that companies are improving their narrative disclosure standards. However, our perception is that standards remain uneven.

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

The complexity of regulation is a factor. Companies have to navigate through the differing requirements of the Companies Act 2006; the Listing Rules; the UK Corporate Governance Code and the Disclosure and Transparency Rules. It would be helpful if there was a unified set of guidance to help companies, especially smaller companies, deliver better disclosures.

The clarity of narrative commentaries in annual reports is also compromised by legal teams going over the text to see if there could be hooks for future litigation. Although some legal protection is already provided by section 463(3) of the Companies Act 2006, it may be necessary for the liability position of directors to be further clarified and protected if more meaningful disclosure is to be encouraged.

A third issue is the disengaged behaviour of many institutional shareholders. If companies do not believe that disclosures are being read or acted upon by external shareholders or stakeholders, it reduces their incentive to deliver meaningful disclosures. In such circumstances, disclosures are not seen by companies as a tool of potential engagement, but as a compliance burden. This is not conducive to meaningful narrative reporting.

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

Yes, to the extent that this is possible.

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

Institutional investors should be more explicit about the information that they require from the narrative reporting of their companies under ownership. Companies are generally happy to incorporate investor perspectives into their reporting framework. But this needs to be catalysed through a meaningful board-shareholder engagement process.

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?

We are not replying to this consultation from an investor perspective. However, the unwillingness of some institutional investors to engage with companies on these issues is a recurring concern.

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)?

N/A

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

Yes, there is scope to reduce the complexity of requirements which have evolved significantly over the last couple of years. There is a place for additional guidance in this area.

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

Yes. Narrative reports could be condensed into a summary of key strategic issues. Detailed supporting information could be provided in a separate document. Given the growth of electronic communication, it is

feasible to publish such information with the same level of prominence as the annual report, for example by including it on the company website. Such a separate document would be particularly appropriate for narrative reporting on environmental, social, community and employee matters.

The need for additional sources of information on the website is relevant with respect to another aspect of disclosure. We are increasingly concerned about the emergence of a dual form of communication between companies and shareholders. Large institutional investors get more detail of strategy, opportunities and issues than smaller shareholders. Although all information is to be made equally available in the public domain, our experience is that this does not always follow. It should be best practice for all presentations to analysts or institutions to be posted on the company website.

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?

The information disclosed by companies to comply with the requirements of the Business Review are effectively equivalent to those which would be contained in an operating and financial review. The main operational difference between the enhanced Business Review and a statutory OFR would be the nature of the audit report, which would be more extensive for a statutory OFR.

Therefore, reintroducing the requirement for a mandatory OFR is likely to have little impact in practice. However, there is a risk that even a limited increase in prescription could be met with an increased number of generic 'boiler-plate' and legally sanitised disclosures that add no value to the users of financial statements. The OFR may also increase auditing costs for many companies.

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?

Ultimately, these are issues for investors and other stakeholders to determine.

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

Yes. Additional best practice guidance and case studies would be a useful means of driving up narrative reporting standards.

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

No. We would not be in favour of an advisory vote on the Business Review. There is already a shareholder vote at the AGM on the annual report as a whole. This is sufficient.

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

Awards which reward high standards in corporate reporting are a useful way of promoting improved practices. In addition, best practice guidance and director training have significant roles to play in improving standards.

For example, the IoD's Chartered Director qualification provides directors with a strong sense of the importance of narrative reporting[1]. We encourage the Government to work with the IoD in raising the profile of director development programmes which incorporate relevant training in narrative reporting.

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?***

If not, please explain including any views on how this might be improved

Many reports suffer from being unduly lengthy. The clarity of the remuneration report could be improved by removing detailed information into a separate document, or simply by making it briefer and more meaningful.

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.

Companies invest significant amounts both in complying with the existing narrative reporting requirements and in providing additional voluntary information. **As companies struggle to recover from the economic downturn, this cost burden should not be increased by additional regulatory requirements, particularly given the potentially detrimental impact of a more prescriptive approach.**

Thank you once again for inviting the Institute of Directors to participate in this consultation. We hope you find our comments useful.

Yours sincerely,

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[1] Some of the organisations that have formally endorsed Chartered Director include: The CBI; Co-operative Insurance; National Association of Pension Funds; Hermes; The Building Societies Association; Investors in People; Secretary of State for Business, Enterprise and Regulatory Reform; Department for Education and Skills; Tomorrow's Company; USS; The British Bankers Association; Investment Management Association; The Institute of Business Ethics; The Quoted Companies Alliance; Institutional Shareholder Services; Association of Investment Trust Companies; and the Local Authority Pension Fund Forum.