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)**

Value of narrative reporting

<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?

Comments
i) Forward looking strategy is now often stated, but in our research of many Business Reviews (BR) we find it is often a "standalone statement", with little linkage to operating divisions. In addition, often we observe few companies provide targets or milestones that would enable investors to detemine the extent to which the strategy has been successful over the past year, or how investors can judge what is expected of the strategy in the future. ii) As regards the principal risks and uncertainities, there continues to be a declaration at a high level (e.g. economic uncertainty) or external actvities (e.g. increased regulatory pressure). Relatively few companies' lists of risks or uncertainities refer to internal or operational risk, or business related elements such as key customers or suppliers. It is also interesting to look, with hindsight, at BP's list of key risks or uncertainties – only 14% of the content related to operational risks, and about 3% to the operational risks associated with drilling and exploration – would this be the same percentages if written now, in the aftermath of the Deepwater Horizon explosion? This may be perceived as correct from the companies' perspectives, but it infers that every internal risk is under control and a level of belief on behalf of the Board that the status quo will continue until impacted by actions not considered in the risk process. Also we seldom see risks that are specifically related to a declared business strategy and may impact on its implementation. Since this is likely to be a basis for investment decisions by shareholders, one would expect greater focus on risks that could affect delivery of the published business strategy.

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

Comments

Companies often provide information on the implementation of their strategy in published analysts' presentations, yet in the BR it can appear that divisional directors make use of the "commercial confidentiality" argument to avoid disclosure. This suggests that the CEO should take greater control of the content of the BR rather than, as is often the case, delegating it to individual functional heads, who write their content in a silo.

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

Comments
We do not have sufficient experience of the content of board meetings to comment specifically. However, our anecdotal knowledge suggests boards discuss a range of issues, many of which are not relevant for a longer term view of the company. We suggest, if this is the case, the board should ask for a set of strategy milestones (or dashboard) and KPIs that could be used for regular review of the business strategy and the business model at board meetings.

<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
If companies adhere to the intent of the BR, then we believe it would be sufficient to enable shareholders to be more active in challenging the board's performance on strategy and risk. However, the problem is that often they do no more than tick boxes. The issue is not about what is laid down but the quality of what is provided. As an example, if we look at one leading financial services company, from 2004 to 2008 there was no description of the strategy in the Annual Report (ARA) (although the word "strategy" was used liberally, but without qualification). We did find a description of the strategy in a 2005 stockbrokers' presentation. For this company; we question how shareholders, other than those knowledgeable of the 2005 presentation, would have the ability to challenge the board.

<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

We do discuss these matters with our clients, but the view may often be "how much do we need to communicate". One of the issues is that CEOs often have a relatively short average tenure and, as a consequence, the strategic statements tend to be more "motherhood and apple pie" rather than a detailed series of actions.

<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
Websites, analysts' presentations and Corporate Social Responsibility (CSR) reports are used. Analyst presentations often have more substance than a Business Review – often because the directors delivering the presentation know they may receive more detailed questioning. Remarkably, the last may be more revealing about the way in which a company operates compared with the ARA itself. This is especially the case if the CSR report discusses issues such as impacts on stakeholders, and reviews the materiality of the various CSR elements.

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

Comments
As far as the current Business Review and the UK Corporate Governance Code are concerned, we regard the requirements as flexible, and do not require reducing or simplifying. The focus of the UK Corporate Governance Code on the business model should ensure companies focus on non financial matters as they relate to the business model and the business strategy. The issue is more related to ensuring that companies do indeed report in a transparent manner – what is currently set out gives companies opportunities to improve their reputations through quality reporting and are not burdensome; they should be part of good business practice. However, there is a need for clarification regarding terminology. We recommend that there needs to be some definitions regarding what is meant by "the business model". We compared the UK Corporate Governance Code, which requires "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", with the comment in the FRRP's 2010 Annual Report, which includes the following statement: "The UK Corporate Governance Code now recommends that companies explain their business model in their annual reports. The Code describes this as an explanation of the basis on which the company generates or preserves value over the longer term and the strategy for delivering the objectives of the

company", which infers that the business model incorporates the strategy. We consider the FRRP's interpretation to be somewhat confusing. We regard the business model as being the means by which the company **currently** operates, so as to generate or preserve value over the longer term, whilst the business strategy is the means by which a company delivers its **longer term** business objectives – this may imply the business model is retained but a business strategy may result in a new or revised business model being introduced. Using an example of a high street retailer, the current business model is reasonably clear, and if its business strategy includes the introduction of new product categories for sale on the high street, then the business model is likely to remain the same. However, if the business strategy is to move from high street retailing to either a mix of high street and internet retailing, or even, 100% internet retailing, then this would necessitate the development of a new business model. Investors would require an explanation of how such a strategy would affect the business model.

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

Comments
Our experience suggests many companies (particularly outside the FTSE100) interpret non financial matters as being CSR. We do not believe this should necessarily be the case. There is scope to require companies to feature non financial matters and KPIs within their operational review, rather than making them standalone in a CSR section (and hence, perhaps, not being valued or considered relevant). The problem is that there are different audiences for the CSR reports and Business Review reporting and combining CSR reporting within the Business Review may lead to confused audiences. To take this approach, however, may mean that companies should be encouraged to have separate CSR reporting, covering matters of concern to all stakeholders, which may be more costly. In addition, there is a need for greater consistency of guidance on quantitative reporting. We commented upon this in our publication "Just how many green house gas reporting standards do we need?" www.thevirtuouscircle.co.uk/NEWS_SEPTEMBER09.html This was referred to in the ASB's review of narrative reporting "Rising to the challenge". Companies need certainty in determining how they should report. They do not require multiple standards, leaving it for them to decide the mode of reporting, with the potential for external criticism.

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 are reluctant to see the introduction of a statutory reporting standard, as we consider this may lead to more "boiler plating" by companies. However, we do see value in providing simpler guidance than that included in the Reporting Statement, of which we see little evidence of its use by companies in guiding their corporate reporting. This guidance could focus on the Business Review (and may be usefully retitled as a "Reporting Statement on the Business Review". It could use the Code's statement on the business model as its platform. In addition it could include a range of best practice examples - relevant to each sector - with the statement reinforcing their use that these are used as guidelines by the FRC as the basis for consideration of non financial reporting in BRs.

<u>Question 10</u>: 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
Main trends and factors - We question whether presently there is adequate information provided on "main trends and factors likely to affect the future…" because there is seldom sufficient information about the company's strategy, other than as a stand alone statement. **Environmental matters -** Generally, there is sufficient information on <u>material</u> environmental matters. **Employees -** Information on employees tends to be less than adequate from a strategic perspective. As an example, strategically, there may be more relevance in reporting on matters such as talent development, the quality of succession planning, employee motivation and productivity. In considering employee areas, such as employee diversity, it is worth pointing out that this

is easier and better for UK based companies, compared with international companies. This is likely to be because collating diversity data at time of recruitment may not be legally possible (as is the case under USA and French laws). Corporate reporting legislation should take account of international practicalities.
Social and community – these issues are, perhaps incorrectly, "well" reported. However, from a shareholders' perspective, we suggest this reporting may lack materiality, and hence be of less use to shareholders – other than to create a "feel-good factor".
Contractual or other arrangements - In general, we consider that companies report poorly on matters relating to contractual or other arrangements. We suggest that this requirement, being limited to "essential" matters enables companies to take a de minimis approach.
Instead, we propose companies should be encouraged (by best practice examples and investor pressure) to provide material customer and supply chain KPIs e.g. customer retention, customer complaints, average revenue per customer, longevity of supplies, supply chain profile, which would provide investors with more relevant non financial insights to enable them to consider operational performance.

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
Some more guidance in the form of best practice examples undoubtedly would be helpful, but they should be sector based. Ideally there should be some scenario examples to help ARA writers understand how the business model and strategy can be best communicated. Sample KPIs are not so helpful, since they would encourage "boiler plating" and may not be 'key' to some businesses.

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

Comments
We suspect that an advisory vote is not practical. The challenge of having an advisory vote on the Business Review is that the BR encompasses a wide range of content, unlike the remuneration committee's report. If an advisory vote is considered useful, then we suggest that it is based on specific areas of the BR e.g. progress on the business strategy.

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

Comments
Other than best practice examples, we suggest the FRC could offer more transparency by giving examples (without necessarily quoting company names) that they regard as good or poor reporting in the various ARA elements. In this context, the challenge is whether the FRC has adequate knowledge about the quality of non financial reporting? There may be a value in bringing together a forum of institutes to set up some standards for best practice reporting.

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
Remuneration and the performance criteria - Generally, there is clear and usable information on these matters, given Combined Code requirements. **Corporate Governance Code -** However, we are mindful of schedule A of the UK Corporate Governance Code, which recommends challenging performance criteria reflecting the company's objectives, including non-financial performance metrics where appropriate. Our view is that if a company communicates its business model and business srtrategy effectively, then the choice of material non financial metrics to be used as KPIs for criteria purposes become reasonably obvious.

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
Our comments in this respect are anecdotal. However, our observations are that better quality reporting of non financial metrics should not add any cost on the basis that they should already be in place in the company. In addition, we believe that the narrative reporting element of company reports can be addressed earlier in a financial year – perhaps commencing two months before their end – which could reduce the pressure on internal resources, which may reduce costs. We question how much of substance (in normal non crisis times) will change over those last two months that would fundamentally affect the content of the narrative reporting.