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:

Y	**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
Company directors do in general provide useful and relevant information on the company's strategy and principal risks and opportunities. However, this is a very subjective area, where what is considered adequate for one user of the accounts may well be considered inadequate and lacking in detail by another. A shareholder with a specific focus in one area (e.g. environmental concerns) will conceivably want to see more than perhaps management think is necessary. Single issue groups by their nature tend to focus on a small number of disclosures in great detail – a level of detail which could obscure the communication to a more general audience. It would therefore be difficult to standardise or legislate in this area for specific items without running the risk of encouraging extensive narrative reporting which is potentially "merely compliant" with the checklist requirements of legislation (a boiler plating approach) rather than narrative reporting which aims to engage with the principal stakeholders (i.e. shareholders) in a relevant and meaningful way about the state of the business and its current and future prospects. A standard checklist type approach to narrative reporting will ensure compliance with the letter, but not necessarily the spirit of, the law. Additionally, this becomes a very difficult area to standardise where the main concern is "quality", which is an extremely subjective concept. Concepts such as "the best" might be aspirational, but are likely to be of little use unless their meaning is clearer. The main concern could be seen as whether or not the narrative reporting is fit for purpose but that again is just as much in need of a clear meaning. It might be assumed that "best" and "fit for purpose" mean the same thing for everyone, but this might not be the case. What could be meant by "high quality" and "among the best" is subjective, a matter of interpretation, and likely to change over time due to changes in perceptions as to what reporting should achieve, or the influence of specific topical reporting trends (e.g. the emergence of a focus of social and environmental reporting over the last 10 years). Inevitably narrative reporting in company accounts has and will continue to evolve. Arguably a simple report which is crystal clear but perhaps lacks certain details may be perceived as having greater value (quality) than a report which

covers all the requirements deemed necessary (quantity), but which is difficult to read or understand.

The purpose of narrative reporting therefore needs to be more clearly defined if it is felt to be lacking in quality. This might suggest how to rectify the perceived failings and arguably the ASB reporting standard already provides all of this necessary detail. However, this question of purpose does raise a number of issues including:

(a) What is the real role for the Report & Accounts, including the narrative reporting, especially in the form of one document? Is this the best or main mechanism for informing the market and the shareholders?

(b) Is the search for transparency and coverage of aspects such as social and environmental issues contradictory with the aim of reducing, or at least not increasing, the regulatory burden? This is part of a wider issue of "clutter and complexity" as the reference at the end of paragraph 2 indicates. The BIS paper tries to cover this in the usual way by qualifying additional requirements as only being necessary if "material". However, it seems clear in the expansion of reporting in recent years that, for various reasons, materiality has not been applied in a way that would mitigate or reverse the trend to voluminous disclosure which is not all really necessary. Also, whether in legal or financial reporting requirements, new disclosures are rarely accompanied by the removal of existing ones, while general guidance tends to mutate into detailed best practice.

As noted below (Question 2) some constraints on detail will also be necessary to avoid giving too much information to competitors, let alone adding to the clutter and regulatory burden of reporting.

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

Comments
Constraints could include considerations of: - confidentiality; - specific budgets or forecasts would be exceptionally price sensitive information particularly where actual results could or actually do differ to expectations or projections; - risk of being overoptimistic or over cautious, although one aspect of this is the tendency is to play safe and disclose rather than not disclose; - do not wish to disclose commercially sensitive information that competitors could make use of; - avoiding "clutter"

While describing an entity's KPI's may be appropriate, it is a significant step to move to disclosing projections and forecasts, together with performance against them; care is needed when published reporting moves from stewardship reporting of the past to forward looking statements which may not then be borne out by events.

Quality versus quantity is also a key issue. There is virtually no limit to the number of disclosure areas or topics that could be included in narrative reporting and the number of ways of measuring targets however defined. There will always be pressure from users of accounts (particularly non-shareholders – other stakeholders) for better information (quality) and more information (quantity) and single issue or narrow focus groups will always want more detail in the areas that interest them.

It is of course possible for single issue focus groups (stakeholders) to become shareholders in companies and seek to add their own agenda to the company's reporting to shareholders. However the Report & Accounts should communicate clearly and concisely to a broad group of investors without getting lost in the "clutter" of irrelevant detail or non-core issues.

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

Comments
Yes it does reflect the issues in general but with the obvious caveat that the information provided is limited by the issues noted in Question 2, namely: - confidentiality - specific future events, budgets or forecasts - over optimistic or over cautious statements - commercially sensitive information.

<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
This question presupposes that all shareholders actively seek discussion with company directors on key issues relating to strategy and risk and that the narrative reporting in the Report & Accounts is the key element for shareholders in making investment decisions. Shareholders want returns, with sustainable good quality earnings and consistent dividend payouts.

It is questionable as to how many shareholders look at the financial statements for information on the company when making investment decisions (buy, hold, sell) as opposed to using the reports of market and company analysts, or indeed simply examining the company's history of dividend payments (returns on capital) and share price movements (capital growth). In general company briefings, dialogues with individual significant investors (often institutional investors), discussions and briefings with analysts all help "tell the story" both in terms of current performance and future expectations, in addition to the information presented in the Business Review, although it should be noted that only a small number of investors have the opportunity to meet directors and such meetings are often directed towards assessing the calibre and credibility of the individuals concerned rather than pressing directors on key issues relating to strategy and risk.

One might ask why CSR and environmental concerns are in the Business Review if it is for the benefit of shareholders as opposed to other stakeholders, except in so far as these issues directly affect earnings, net assets, the company's share price and its future sustainability and profitability. However, the danger with such requirements is that, as noted in Question 1, in the current climate the tendency is very much to include the detail despite the references to materiality.

<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
N/A

<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, and dialogue with the company, corporate social responsibility report)?

Comments

We are a preparer rather than a user, but in general we see company briefings, dialogues with individual significant investors (including institutional investors), discussions and briefings with analysts all help “tell the story”, both in terms of current performance and future expectations, in addition to the information presented in the Business Review (see also Question 4).

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

Comments

There is definitely scope to both reduce and simplify the requirements. In the UK in recent years the large growth in the size of the Report & Accounts as a printed document has been due to the growth in the narrative reporting section as much as to the impact of IFRS on the financial statements. Arguably a simple report which is crystal clear but lacks detail should be perceived as having greater value (quality) than a report which covers all the requirements that might be deemed necessary in some circumstances (quantity).

An approach of (mere) compliance is encouraged by a checklist mentality. Both company directors and auditors can be wary of leaving out something which they might think was not required, but where someone might disagree with the omission, especially with the benefit of hindsight. Consequently, as noted in Question 1, company reports have tended to become overloaded with irrelevant detail and clutter and the force of legislation in this area could make things worse rather than better.

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

Comments

Whether information could be better presented is subjective as “beauty” is often in the eye of the beholder. We would however start from the premise that management should know best how to present the key challenges and successes of the business.

We believe that it is difficult to standardise or legislate in this area for specific items without running the risk of reporting which is “merely compliant”, a boiler plating approach, rather than narrative reporting which seeks to engage with the principal stakeholders (i.e. shareholders) about the state of the business

and its current and future prospects.

A standardised approach to presentation might be seen to add some comparability, but standardisation is not always a path to useful communication if it is detailed and would not enable a company to communicate with its members in the way it thinks is best.

However, it should be noted that on-line presentation does give companies an opportunity to collate data in a more useful way making on-line reporting more user friendly, for example by pulling data in from different parts of the Report & Accounts to support KPI results. The existing regulatory environment does not always support a more flexible on-line approach compared with the standard format of book-bound reporting.

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
As noted above under Question 1, this is a very subjective area and it is difficult to standardise or legislate in this area for specific items. Particularly it is difficult to see how legislation could improve upon the ASB reporting standard. As also noted, the purpose and use of narrative reporting should be more clearly defined, if it is felt to be lacking in quality, and this might suggest how to rectify the perceived failings. It should also be recognised that narrative reporting has developed over time and continues to evolve, with content influenced by what is perceived to be "good" narrative reporting. It could be said that if the market really uses aspects of the narrative reporting then market pressure should ensure the development of quality reporting in those areas.

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
Again we are a preparer rather than a user but it should be noted that there is a danger of duplicated information as most quoted companies produce additional environmental / CSR / sustainability reports etc for the benefit of other stakeholders in addition to the information contained within the Business Review for the benefit of shareholders. While information on employees will often fall under one of the key strategies for most companies, the value of the rest of the issues is less clear, hence reporting "to the extent necessary" seems appropriate. However, in practice, this again takes us back to the materiality issue mentioned earlier.

<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
Arguably the ASB reporting standard provides all of this necessary detail, and further statutory "guidance" would merely encourage a form-filling, check-list approach.

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

Comments

It is difficult to see what purpose would be served by having an advisory vote, given our comments under Question 4, above.

<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
As noted in Question 1, there are broad issues on what is meant by "quality" to be resolved while arguably the ASB reporting standard provides all of this necessary detail. We would hope that the continuation of the recent work on the complexity and clutter in reporting, under the auspices of the FRC, will yield some improvements in the approach to reporting both narrative and financial information In addition to the regulatory pressure exercised by the Financial Review Panel, there clearly is some pressure exercised by the various bodies (such as Black Sun) who regularly report on the quality of native reporting. While these publications and the various awards for CSR, environmental or business review reporting have some effect, these are perhaps of questionable value to shareholders, if we assume that shareholders would prefer require clear, concise reporting which is fit-for-purpose rather than necessarily "the best". We are also dubious that the "expert panel" suggested in paragraph 30 would achieve much, unless there was clarity upfront as to the purpose and users of narrative reporting, together with its interaction with other communication routes, and the experts were judging by open and accepted criteria. As a further point it should be considered that larger companies tend to be good corporate citizens and do produce high quality reporting, devoting considerable resources to the exercise. Smaller companies may not be able to match that level of commitment.

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
Arguably yes, but perhaps this a question of degree (quality) as the reporting requirements are already extensive and in the current climate result in a large and complex volume of disclosures. The Remuneration Report is often the largest section of the Directors' reports.

Costs

Question 15:

If you can provide any information on costs associated either with the existing narrative reporting requirements e.g. 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
It is difficult to estimate the full impact in this area. Even if the requirements for narrative reporting were sufficiently clear and simple, a company would still have to estimate the impact of any disclosure to its shareholders, analysts, employees, special interest / single focus groups and other stakeholders, and ensure that there were no legal, governance or reputational issues with any of the information disclosed, or issues requiring consultation with unions, staff councils (employee representatives), significant shareholders, brokers and analysts, etc. Any information disclosed in the company's Annual Report and Accounts could be of great interest to a wide variety of stakeholders and the company must ensure that the information is accurate and auditable. Any information produced purely to meet external reporting requirements and so not already used by management to run the business, will have a cost which is not justifiable in a business context.

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