The Future of Narrative Reporting

Response by the
Local Authority Pension Fund Forum

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FEEDBACK ON THE FUTURE OF NARRATIVE REPORTING

Background

The Local Authority Pension Fund Forum (LAPFF) was set up in 1991. It is a voluntary association of 52 local authority pension funds based in the UK. LAPFF exists 'to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders to promote corporate social responsibility and high standards of corporate governance amongst the companies in which they invest.' The Forum's members currently have combined assets of about £90 billion. PIRC is the Research and Engagement Partner to LAPFF.

The Forum sets out its response below to the BIS consultation on the Future of Narrative Reporting issued on 2 August 2010. The consultation invites views on the current UK narrative reporting framework, with a particular focus on the business review and directors' remuneration report. The Forum has taken the opportunity to provide our view on those consultation document and consultation questions, which we consider relevant to our activities.

Value of narrative reporting

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

The usefulness of this information naturally varies by company and by audience. Overall, we find such information of limited use.

<u>General observations</u>
In our opinion, company directors make very little distinction between the provision of information and the provision of noise.

We define information as data that shareholders can use to facilitate a forecast of future performance and/or behaviour.

In contrast, we consider noise to be data shareholders cannot use to facilitate a forecast of future performance and/or behaviour.

After analysing disclosures on forward-looking strategy and principal risks and uncertainties across a large universe of UK companies, despite evidence that most companies make an effort to communicate their strategies, we are forced to conclude that much director reporting on these subjects is noise.

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Forward looking strategy

We conceive a firm's strategy as the means by which it performs a *different* activity than its rivals in order to secure competitive advantage and make economic returns; or as the means by which it performs a similar activity *better* than its rivals for the same end.

Using this as a starting point, we believe that most director commentary on the company's forward looking strategy fails to discuss the essential ingredients of strategy, as we understand the term.

Principal risks and uncertainties

We find that although the vast majority of companies define the principal risks and uncertainties they face, few make the effort to scale these in their reporting to shareholders and, by doing so, give shareholders a sense of their weight and likely impact.

In prioritising key principal risks and uncertainties, companies would benefit shareholders by communicating the time horizons over which they might unfold/impact.

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

We are told by company directors that the principal constraint on more useful disclosure on these issues is their sensitive nature vis-à-vis the company's competitive positioning.

To this we reply in the spirit of Gary Hamel[1]:

- A company's competitive advantage is not based on what it does but on how it does it (the tacit processes that are difficult to copy), and

- What a company does (if it works) is going to be copied irrespective of whether it discusses it with shareholders or not – so the company might as well discuss it with shareholders.

An additional constraint is that, in theory, discussions of these issues need to address the interests of a diverse group of shareholders, many of which (long-term, short-term, responsible, fundamental, momentum, etc) have different interests and information needs.

Nonetheless, we believe the biggest constraint on providing shareholders with information pertaining to these issues (rather than with noise) is the mindset of those responsible for the content of a company's narrative report:

[1] Gary Hamel is the author of 'Leading the Revolution' and 'Competing for the Future'

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- Narrative reporting appears to us to be largely an exercise in compliance rather than an exercise in communication, and

- If the authors start with a misconception of what constitutes strategy (as above) then this is the jumping off point for the provision of noise rather than the provision of information about how the company intends to compete and make money, and what this means for risks and uncertainty.

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

In our experience shareholders rarely get good disclosure on the minutiae of matters discussed in board meetings, which makes this question difficult to answer.

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

In our experience the quality of a company's disclosure frequently prompts direct engagement with the company.

As noted above, in our opinion the data provided by directors rarely provides shareholders with the information they seek. However, it works well when the picture directors paint of the company in public does not square with a shareholder's understanding of the company's strategy and performance – prompting shareholders to press for more – or when it presents shareholders with a starting point for a more extensive discussion of a particular point or points.

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?

It is common practice for us to request further disclosure and/or meetings with companies that we believe are not providing what we regard as sufficient clarity to understand a company's performance, its strategy or its policies and processes. To further inform such requests or preparation for such meetings, information may be sought from credible external sources including, where relevant, from other stakeholders of the company, including investors. To some degree, key issues of strategy and risk are sector as well as business specific, and the more informed a party is on these broader market conceptions of risk and appropriate strategies to respond to these, the more useful the exchange.

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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)?

LAPFF will initially look to companies' Business or Operating and Financial Review for an identification of key risks and uncertainties faced by the company and for it to set out its strategy accordingly. However, all information produced and published by the company is taken into account, including that sourced from corporate websites and separate CSR reports. This is used to provide a broader picture of how the company assesses such issues, and the degree to which these are fully articulated and integrated into the core business strategy. This, in addition to other information sources and research, is then used to inform subsequent dialogue with the company.

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

One approach could be for directors to address their narrative reporting to 'intrinsic investors' alone, i.e. by identifying and reporting on those issues that are most relevant to shareholders that take a long-term and holistic view of company performance. In this way, directors would have the scope to report on many aspects of company performance such as management of human capital, which are crucial to the long-term success of a company, but on which disclosure is currently of poor quality.

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

In our opinion, the paradox of narrative reporting is the almost universal absence of a narrative thread in narrative reports, which links the subject matter the company reports on. That is: companies do not present the information under discussion within the context of an overarching story that helps shareholders make sense of what they are being told.

We believe stories work well because they help readers to assimilate information; because they are far easier to recall than data; because they dovetail with the way in which shareholders naturally categorise companies (a "green company," a "concept stock," a "growth company," etc), and because they can convey large amounts of information succinctly (as the reader does much of the work, expanding the story for themselves).

That is not to say we suggest presenting data in story form a reporting requirement. However, we do believe a company's communication strategy will

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be enhanced when it is encouraged to understand the power of story telling versus the sterile nature of much corporate reporting.

Business Review

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?

A key theme that emerged during 2006 for the Forum was to make the most of the opportunity presented by the introduction of the business review reporting requirement. The Forum remains committed to improving the quality of corporate reporting and notes the role of ASB Reporting Statement as the only available best practice guidelines for Business Reviews. Thus the Forum would support the reinstatement of all additional elements of the OFR excluded from the current Business Review reporting requirements.

The Forum considers that these guidelines provide the more specific emphasis on certain factors to guide directors in providing the most useful disclosure for shareholders. For example, the OFR guidance is more specific on the provision of forward looking information in that it must be prepared 'so as to assist the members of the company to assess the strategies adopted by the company and the potential for those strategies to succeed.' Another example of relevant information required to be disclosed by the OFR but not the Business Review is 'a description of the capital structure, treasury policies and objectives and the liquidity of the company'. Additionally, on environmental and social reporting, the OFR guidance asks not only for information on policies but also, what is far more relevant to shareholders, for 'information about the extent to which those policies have been successfully implemented'.

10. The business review provisions require quoted companies to report, to the extent necessary, on:

- **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**

Is this information useful to you?

To the degree that it qualifies information rather than noise we find such disclosure useful.

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How do you use it?
It enables us to benchmark what we believe to be best practice in regard to certain policies and processes and to assess relative performance across large numbers of companies.

Could disclosure be improved? If so, how?

- Greater use of standard definitions would facilitate more accurate comparative analysis.

- The provision of raw data (or access to raw data) would enable shareholders to manipulate it according to their own analytical framework.

Are there key issues which are missing? If so, please explain?

- Capital allocation: we believe the process by which a board allocates capital, including the trade offs it makes between competing projects and stakeholders is critical to a shareholder's understanding of a company's ability to create value and its orientation to stakeholders.

- The ingredients of strategy: in our opinion, much reporting is dedicated to telling shareholders what a company does rather than how it creates and maintains a competitive advantage over rivals – which we believe is an essential element in the equation for value.

- Employee engagement: our research suggests the level of employee engagement in a company is often a determining factor in company performance. Nonetheless, whilst we see a great deal of (boilerplate) reporting on how companies attract and retain staff we see very little (almost no) discussion of the policies, process and cultural factors companies use to motivate people to perform.

- M&A processes: The average large company gets nearly a third of its growth – 3.1 percentage points a year – from M&A.[2] In turn, evidence suggests that M&A success and failure (measured in shareholder value creation or destruction) can be largely attributed to the quality of a company's M&A process (how it screens acquisition candidates for strategic fit, how it conducts detailed analysis of how customers will react to the deal, and how it codifies lessons learned from prior M&A experience, for example).[3] Nonetheless, in our experience, companies that employ M&A in their growth strategies rarely provide their shareholders with information that would enable

[2] Patrick Viguerie, Sven Smit and Mehrdad Baghai, The Granularity of Growth: Making Choices That Drive Enduring Company Performance, McKinsey & Company 2007
[3] David Harding and Sam Rovit, *Mastering the Merger: Four Critical Decisions That Make or Break the Deal*, Harvard University Press, 2004

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them to judge the quality of their M&A processes ahead of time, or the opportunity to provide feedback on their those processes.

- ESG contribution to strategy and performance: Although a substantial proportion of companies refer to environmental, social and governance (ESG) matters in setting out their strategy, few companies comment on how their ESG performance contributes to this strategy according to our definition of the term and further make the consequent significant link to performance.

- Environmental reporting: In its response to the draft Climate Change Bill consultation in 2007[4], the Forum stated its belief that the government should take the bill as an opportunity to make corporate reporting on greenhouse gas emissions mandatory by integrating a standard into the narrative reporting guidance for the Business Review and in the stock exchange listing requirements. The Forum considers that a large number of companies are still not addressing the risks posed by climate change, nor indeed the opportunities presented, and that investors would be better served by fuller reporting on this issue.

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

Best practice examples of what good narrative reporting looks like appears a useful exercise to us. In particular, the Forum would support the use of defined key performance indicators (KPIs), such as guidance from DEFRA on environmental KPIs. The Forum has used DEFRA guidance since 2001, when focussing on corporate carbon reporting. More recent guidance[5] shows that taking into account issues specific to each sector, 80 per cent of companies are likely to have five or fewer KPIs. The Forum does not consider this to be onerous for companies to follow.

In its response to the Carbon Disclosure Standard Board's (CDSB) consultation on its reporting framework[6], the Forum noted a single reporting framework is useful as part of a comparison of company practice across sectors and geographic regions. The CDSB document also provided an example of best practice reporting from 'Typico plc' which was valuable for demonstrating proposed actual practice in reporting, and the range of relevant issues that could be included related to company strategy and long term value building.

[4] www.lapfforum.org/pubs/consultation_responses/CC Bill response.pdf
[5] Environmental Key Performance Indicators, Reporting Guidelines for UK Business, DEFRA, 2006
[6] www.lapfforum.org/pubs/consultation_responses/CDSB consultation response.pdf

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

The Forum supports the overarching principles of transparency and accountability. In considering whether to mandate a particular resolution addressing the adequacy of a Business review, investors should be considering the extent to which this would increase the regulatory burden on business and whether this would add cost into the system that would exceed the benefit.

To ensure company management is reporting in a material and relevant manner, the Forum considers that, in the same vein as companies being required to put their Remuneration policies to shareholders for approval, on balance it would be beneficial to have an advisory vote on the Business Review.

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

We are not sure that company directors need more guidance in order to enable them to provide more useful information to shareholders – just a different mindset.

We do, however, believe establishing and highlighting model behaviour is likely to encourage others to emulate best practice. Naturally, care should be taken to ensure that the individuals and/or bodies that dispense relevant accolades are credible in the eyes of the target audience.

Directors' Remuneration Report

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

The current disclosure requirements on total remuneration paid to directors do not always provide information about the *total* remuneration paid to directors, and how this is made up. For example, the Forum has noted that some of the enhanced benefits available to directors are not covered by the mandatory

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disclosure requirements and has called for greater transparency on the pension arrangements for senior executives[7].

Boardroom pensions that have significantly higher accrual or contribution rates than those available to other employees could be seen as unfair, if not fully explained. Disclosure should provide more information on accrual rates, payments in lieu of pensions and the reason behind any difference in retirement ages between board level and other employees.

We do agree that payments made to directors should relate to the company's strategic objectives. Nonetheless, we believe many firms misinterpret this principle.

This belief is based on our observation that many firms assert that their remuneration policies are aligned to their business strategies. Nonetheless, in our opinion, the reality is that they are largely aligned to the *outcomes* of strategy (such as earnings per share growth) rather than to the *ingredients* of strategy (such as ensuring high levels of customer satisfaction or product innovation).

We are also frequently frustrated by the degree to which companies fail to provide sufficient information for shareholders to judge the performance criteria for directors as pertains to annual bonus awards, and the basis on which performance targets (short- and long-term) are deemed to be stretching.

Even in circumstances in which performance criteria and performance against these are adequately disclosed, we believe shareholders are often precluded from understanding the process that determines final levels of reward. For example, the weights given to different performance metrics in annual bonus schemes are seldom provided and Remuneration Committees disclose little about the metrics they consult, and the process they adhere to, when they apply their discretion to determine whether director performance against performance metrics correlates with the committee's understanding of underlying financial and non-financial performance.

[7] www.lapfforum.org/pubs/press_coverage/LAPFF_exec_pensions_PW_June_2010.pdf

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