# The future of Narrative Reporting.

From Legal & General

## Introduction

Legal & General has approached this Consultation from two standpoints:

a) as a FTSE-listed Company with corresponding reporting requirements, producing Annual Reports which are independently ranked in the top quartile of the FTSE350, and;

b) as a major UK institutional investor with holdings of over 4% in the FTSE All-share Index and hence a major role in monitoring and engaging with other listed companies. In this context our stated mission is "*..to engage with companies and vote as shareholders on behalf of our clients in a manner that maximises value and promotes integrity".*

Our starting-point in responding to this consultation is that the UK already enjoys a high standard of corporate reporting. The introduction of a narrative reporting regime for the "front half" has been helpful, but in our opinion the previous government's decision to implement an OFR, and its subsequent retreat from this position, made very little difference to the quality of disclosure. More substantive changes have been the growth of web-based reporting, which we believe is beneficial for companies and their shareholders, and the introduction of short-form alternatives which present a useful alternative, particularly for retail shareholders.

Ultimately, the drivers of good narrative reporting are twofold. Strict compliance is enforced by the presence of directors' liability for the content of the Report & Accounts, while better than average narrative reporting is likely to be valued by shareholders.

We now turn to address the questions raised in the consultation.

## Value of Narrative Reporting

**1. Are company directors providing useful and relevant information on the company's:**

**i) Forward-looking strategy and**

**ii) Principal risks and uncertainties?**

We believe that, while there is broad compliance with the narrative reporting requirements, qualitative standards of narrative reporting are mixed. This view is borne out by independent survey evidence for example by independent observers such as FutureValue. (http://www.futurevc.co.uk/)

In the two areas highlighted by this question – forward-looking strategy and principal risks and uncertainties - a wide range of approaches are adopted. In particular, there is variation between those companies which provide a basic short-term outlook statement and overall statement of strategy and those which provide a more detailed account of how strategy is applied to individual business units and divisions.

There is also variation in the treatment of Principal Risks and Uncertainties ("PRUs"). The main issues here would appear to be lack of a clear view as to where in the front half of the report to place this section (ie whether it belongs in the governance section or nearer the front of the report), whether to make the PRUs generic or specific, and whether to differentiate between those risks which are wholly external to the company (eg economic changes) and those where the company has greater control (eg systems failures).

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

In terms of discussion of strategic issues, the main constraints for the company issuing the report are internal: directors are understandably cautious about forward-looking statements or statements of future strategic intent which by their nature are difficult to verify to a standard that is acceptable to the company's auditors and legal advisors. As such, there is a tendency to dilute strong statements or comments which reflect opinions held rather than verifiable facts between drafting and publication.

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

In the case of our own Report & Accounts, the majority of the strategic issues under discussion (both for the company overall and for business divisions) have been the subject of Board discussion during the year in question. For PRUs, these will have been discussed and approved by the Group Risk Committee. Other aspects of the narrative reporting content – for example those relating to Corporate Social Responsibility – will have been discussed by relevant Board Committees.

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

We believe the provision of a narrative report is broadly helpful to shareholders as part of a company's broader investor relations programme. We would note, however, that in our experience the extent of involvement by retail shareholders on issues of strategy or risk is very limited, and such shareholders may find a short-form Summary Financial Statement ("SFS") more useful. Institutional shareholders tend to rely more on analyst and shareholder presentations and meetings with company management than on the narrative content of the Report and Accounts, although research (FutureValue) does suggest that there is a correlation between high-quality narrative reporting and share price performance.

**5. If a company does not provide sufficient or material information to you, do you challenge it? Is there anything which could help you do so?**

We do challenge where insufficient information is provided. This is part of our programme of engagement on a variety of Environmental, Social and Governance issues (25 meetings were held on environmental and societal issues and 133 meetings were held on governmental issues with investee companies in 2009). This programme is run alongside our ongoing engagement with investee companies on performance issues. Engagements of this nature are usually directly with the Board of the company concerned, and occasionally (on governance matters) with the relevant company Chairman or Senior Independent Director.

We recognise that access is easier for us as a major institutional shareholder (indeed, often the largest shareholder) than for smaller shareholders. Nevertheless, even as a 4% shareholder, there is little influence that can be exerted against a recalcitrant investee, especially as in the case of index-fund investors, selling the holding in the company in question is not available as an option.

In terms of facilitating challenge on disclosure, we believe that this process would be facilitated by broader changes to the way in which institutions engage with investees on governance issues, for example enabling investors to work together without the risk of forming concert parties.

**6. What other sources of company information do you use and how valuable are they (eg information provided on the website, analysts' briefings, dialogue with the company, corporate social responsibility report)?**

As mentioned above, we use a wide variety of information sources, the most useful of which are dialogue with the company and analyst briefings. While not within the scope of this consultation, the "back half" of the Report and Accounts is also of paramount importance. Corporate Social Responsibility Reports are widely used by specialists, both within institutional investment firms and by campaigners within NGOs. The use of company websites raises interesting questions, and we discuss this separately below.

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

Among the most difficult decisions which a company has to take with respect to annual reporting is the judgement of how much detail the Annual Report & Accounts (ARA) should include. Surveys and anecdotal evidence suggest wide disparities in the way different types of shareholders use the ARA document. For many retail shareholders, the full document (in some cases substantially in excess of 100 pages) may simply present too much technical information to be useful. There are also substantial cost and environmental impacts involved in printing and distributing a full ARA for all shareholders.We therefore support efforts to simplify reporting requirements. One way to take this agenda forward would be to further encourage use of web-based reporting.

**Use of Online Report & Accounts and Summary Financial Statements**

Legal & General reports on two accounting bases and as such has an ARA which in totality extends to some 200 pages. We have approximately 45,000 shareholders. For the 2006 ARA, the decision was therefore taken to encourage as many shareholders as possible to make use of a high-quality html version of the ARA online. As this document has evolved over the last three years, we have been able to incorporate increased functionality to give online users greater flexibility in the way they order and present data. Users can print a PDF version if they choose.

Meanwhile, those who expressed a preference for print were, moreover, encouraged to use a short-form document, the Summary Financial Statement ("SFS"). Naturally, any shareholder can request and receive a full printed ARA should they want it. The consequence of this has been that, as at the 2009 ARA, 2,557 shareholders (or 5.6%) expressed a preference to receive the full printed ARA. Shareholders requesting the SFS were 7,207 (15.6%)

Moreover, for 2009, our CSR report has been only available online. This enables us to include much more granular information of the sort used by CSR analysts. Since launching this online CSR Report, we have not received a single request for a printed version.

In our view, this example (which is by no means unique) presents a strong case for developing a regulatory framework which permits maximum use of online reporting, minimising the need for printing.

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

Current arrangements allow a considerable degree of flexibility in ordering the content of the "front half" narrative report. We believe this flexibility is helpful: the optimum narrative (with a clear 'beginning, middle and end') will vary from company to company and this is a decision best left to companies themselves. A more prescriptive approach is likely to encourage 'box-ticking' rather than the preparation of a clear and coherent narrative. That said, however, it should be clear to companies that both Key the Performance Indicators ("KPIs") and the PRUs must be prominent in the front half of the Report.

**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?**

We note the Coalition commitment to reinstating an Operating and Financial Review "to ensure that directors' social and environmental duties have to be covered in company reporting and investigate further ways of improving corporate accountability and transparency".

In our view, the decision by the last government to move away from the OFR made no material difference to narrative reporting practices. It is our view that the UK already enjoys high standards of corporate reporting and we would be sceptical as to whether a statutory reporting standard would lead to improvement: it is more likely, in our opinion, to lead to greater box-ticking which diminishes rather than enhances the preparation of informative narrative reports.

We see a particular issue with the reporting of social and environmental aspects of a company's performance. Current best practice encourages these items (and particularly their relationship to the company's business performance and strategy) to be covered in narrative reporting. However, specialist investors such as ethical fund managers and NGO's tend to require a high level of granularity in the information they use on environmental and social performance, and this is generally best covered in a separate, cross-referenced, CSR report, often made available through the company website. Including this level of detail in the main Annual Report & Accounts ("ARA") is likely to make the main document increasingly unworkable for the main body of shareholders, whose primary focus is on the company's financial performance. We therefore support the current arrangements for the Business Review under the Companies Act 2006 whereby these issues need to be covered in the Business Review only to the extent necessary for an understanding of the company's

business, with more detail being made available in a CSR report as a matter of voluntary good practice.

**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?**

These are useful headings. In particular, the requirement to comment on external factors likely to affect the company's business performance is a useful adjunct to the PRUs which should likewise highlight external threats.

**ii) Could disclosure be improved? If so, how?**

We feel it is difficult to legislate or regulate specifically for better disclosure without running the risk of creating a 'box-ticking' culture where items are covered in a way which meets the strict requirements of the rules but does not add insight to the company's business operations. However, we would suggest that the overall quality of disclosure could be improved by removing the current optionality which exists over whether certain items in the front half of the ARA are inside or outside the Business Review ("BR"). In our view the simple solution, whereby the entire front half is inside the BR is the most appropriate solution.

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

We feel the current prescriptive list of issues as summarised above is sufficient.

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

It should be noted that the selection of KPIs is entirely at the discretion of the Board. There is a wide variety both in terms of the number of measures chosen and which measures are included. This variation applies to financial KPIs and, even more so, to non-financial KPIs. While different sectors and business models will require different KPIs, good practice would seem to suggest that: a) KPIs should be limited in number (not all measures can by definition by "key"); b) for comparability purposes, KPIs need to be in place for several years, rather than being redefined annually, so that good numbers in a particular year do not automatically become KPIs, and; c) there should be a more explicit link between KPIs and discretionary elements of directors' remuneration.

Guidance on KPIs would be useful: but only to the extent that it is consistent. There is a case therefore that guidance is disseminated primarily through auditors rather than to individual companies.

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

We see little value in this proposal. Shareholders already vote on the acceptance of the Annual Report & Accounts (ARA) at the company's AGM, although in practice this rarely results in a negative vote. The ability of shareholders to reject the Report & Accounts nevertheless amounts to a powerful threat to a Board and ensures focus both on the front and back halves of the ARA. Moreover, the regular opportunity to vote on acceptance of the ARA acts as a proxy opportunity for a vote of confidence in the board as a whole and is a potentially important aspect of the governance process.

As such, we feel an additional and unnecessary level of complexity would be introduced by facilitating a separate vote (albeit only advisory) on the front half of the ARA. Would a negative vote, for example, be treated as a criticism of presentational aspects of the front half, or as something more akin to a vote of confidence? What would happen in the event of a negative vote on the front half and a positive vote on the ARA overall? Would an advisory vote apply also to Summary Financial Statements, if these are the primary means of communication with retail shareholders?

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

A number of non-regulatory mechanisms already exist. These include rankings of the sort alluded to in para 30 of the Consultation Document (again, see the research on the FutureValue website) as well as numerous reports on best practice and awards, organised by bodies including the Investor Relations Society, the Strategic Planning Society and ARA design and production specialists. A company's auditors will also frequently provide feedback and advice on best practice.

We do not feel that there is a need for an additional government-sponsored ranking process, or for a panel of experts to be convened (convened by whom?). While there may be scope for BIS to circulate examples of good practice, in the absence of evidence of rule-breaking we feel it is would be an inappropriate use of resources for government to be offering detailed commentary on the reports which companies submit to their shareholders.

**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 Remuneration Report is one of the most actively referenced parts of the ARA, and frequently viewed of the SFS. One of the additions we made to this section of the Report in 2009 was to add a summary of the remuneration report, highlighting key content and directing readers to further information on subsequent pages.

## Potential Costs

**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.**

Beyond time spent by finance and company secretarial staff and management, the principal tangible costs associated with the ARA relate to design, printing and mailing. The first is largely discretionary, and the latter two can be substantially reduced by migrating shareholders online. In the case of a company with a large shareholder register (for example a demutualised company or a privatisation stock) these print and post savings can be very considerable.

Except insofar as they might add to the length of the ARA, we do not see the ideas and proposals discussed in this consultation adding in any material sense to the cost of reporting.