**Department for Business, Innovation and Skills**
**The future of narrative reporting – a consultation**

**RAILPEN's Comments on Detailed Questions**

## Introduction

In assessing the issues associated with the current narrative reporting framework, it is important to consider whether or not there is in fact a problem with the framework and its application by companies. Some companies already report to a high standard, providing shareholders and other stakeholders with a forward looking and meaningful view of the company. This suggests that effective reporting is a prize that is not beyond our reach. Unfortunately there are still plenty of other companies that continue to report only to a level of bare compliance with reporting regulations. Consequently Railpen considers that there remains plenty of scope for improvement and therefore welcomes this opportunity to respond to the Department for Business Innovation and Skills' consultation on the future of narrative reporting.

## 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?**

Although there have been some improvements in recent years since the introduction of the Business Review requirements, much of this, with a few commendable exceptions, has been in form rather than substance with too much boilerplate disclosure, often in legalistic language, which gives limited insight into how the company's strategy is formulated.

Effective narrative reporting should provide the reader with a clear view of the company's business and strategic direction. Ideally, narrative reporting should provide a clear statement as to the company's objectives and how it plans to achieve them, as well as the key risks associated with the strategy. This should be in addition to disclosure of performance against its objectives over the reported year, and the longer term.

In practice, narrative reporting tends to focus on past events, rather than setting the forward-looking strategy and principal risks. Companies seem to struggle with meaningful forward looking disclosures and often the linkage to strategy is retrospective rather than prospective. This is possibly due to the backward looking nature of financial reporting, and may be an effort by the company to correlate the narrative with the financial results.

The reporting of risk is superficially more comprehensive with lengthy lists but with limited effort to indicate which risks are more significant in the board's opinion. We would prefer to see briefer lists of risks that arise from the company's specific strategy and operations rather than a generic list. We note that the remit of the Financial Reporting Review Panel (FRRP) has been extended to cover such disclosures and we welcome its attempts to discourage generic lists of risk with no serious effort to indicate the major risks.

Many companies see the annual report as a compliance exercise whilst others see it as a marketing exercise. Neither approach is very informative despite the increasing length of reports as too much of the material is discursive rather than relevant. We consider that

reporting should be seen as neither marketing nor compliance but present a balanced view of the company in its own words rather in some formulaic phrases.

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

We consider that there are number of obstacles both real and apparent to better reporting on these issues. In part it is a case of perceived constraints.

The most important constraint arises from directors' concerns that the provision of forward-looking information which proves to be wrong or misleading could expose them to litigation. Although such fears should not be dismissed, it is important to note that Section 463 of the Companies Act 2006 provides a safe harbour in that a director will be liable for any loss suffered as a result of an untrue or misleading statement in the directors' report, the remuneration report or the summary financial statements.

We understand that a director will only be held liable in relation to statements which are known to be untrue or misleading or if there was a deliberate attempt to conceal a material fact. This appears to us to be quite a high threshold of safety and we do not consider that disclosing the key strategic issues for the business and the key risks that it faces should contravene section 463. However, perhaps more clarity from the Government is needed on how this section of the Act is likely to be enforced, as this could be an important factor in improving the quality of reporting across the board.

The piecemeal and incremental evolution of narrative reporting in the UK has inadvertently encouraged a silo approach in that many disclosures are scattered in different parts of the report without a unifying theme or suitable cross references. Some of these disclosures are audited whilst others are not and it is often far from obvious to the reader whether a particular piece of text is audited or not. We suggest that a more cohesive approach to reporting would be helpful in this context as would greater clarity on the matters that need to be audited.

A further difficulty with narrative reporting is in balancing the requirements of different stakeholders and to gauge the report's audience. As a result, companies sometimes attempt to report to too many stakeholders and the size and scope of the report becomes a major concern. One of the key challenges for corporate reporting is to create reporting to meet the necessary regulatory requirements, whilst effectively informing shareholders and other stakeholders.

A further constraint on companies providing forward looking information and principal relates to potentially sensitive information. Investors do not expect companies to report on all aspects of their corporate strategy, and are typically understanding of the difficulties companies face with respect to legal requirements, or competitive advantage. As shareholders, we do not want our portfolio companies to disclose detailed information which could be commercially damaging. The challenge for companies remains to provide information which is material and relevant to the stakeholders, and which is also genuinely informative and forward-looking.

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

It is hard for investors, as outsiders, to know whether or not a company's reporting reflects boardroom discussions as we are not party to these discussions and do not have access to board papers. We would hope that the vague references sometimes found in annual reports

are not indicative of the debate at the board and we would prefer that any material issues discussed by the board are better reflected in the annual report.

Clearly companies are better placed to answer this question than investors. We hope that they will respond meaningfully to this question in order to provide some indication to investors of the breadth and depth to which particular issues are considered.

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

It is important to remember that narrative reporting is only part of a company's reporting process. Much of the important information needed by investors is provided continuously throughout the year through meetings, presentations, preliminary announcements and interim results. The annual report and accounts are prepared primarily for shareholders as the providers of risk capital and owners of the company, and should provide them with both forward and backward looking information to allow them to asses the company's prospects and to hold the directors accountable for their stewardship.

**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 in regular dialogue with quoted companies in our portfolio, and this includes engagement on issues such as disclosure and transparency. We will also consider taking voting action where engagement on such issues fails or where we feel that disclosure of material information is weak or inadequate. We have several examples of this in relation to remuneration report disclosure.

We also note that report users are able to report inadequate reporting to the FRRP which has various investigatory and enforcement powers. This channel is not well known and perhaps deserves greater prominence.

The FRRP helpfully indicated in its 2010 annual report that there is an increasing interest in narrative reporting and that information requests to companies often included concern regarding inconsistencies between the narrative information at the front end of the report and the financial information at the back end. We consider this type of enforcement and oversight to be useful. We welcome the expanded role of the FRRP to include narrative reporting and we hope that the FRC will continue to develop this further and to publish annual reports on the findings. We also hope that the Government for its part ensures that there are adequate resources for the FRC to take this forward.

**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)?**

Investors use a variety of sources of publicly available information from the company and other data providers. Some of the most useful information is obtained through engagement with companies and their directors.

We certainly believe companies should make full use of their website. Whilst some companies have useful and informative websites that are easy to navigate, many do not use their websites effectively whether by failing to put key information online or through poor presentation.

We consider that corporate social responsibility or sustainability reports can provide useful information on environmental, social and governance risks, depending on the nature of the business. However, if these risks are material and relevant to the company, there may be a case to suggest that this type of information should be reported in the annual report at least in summary rather than exclusively in a stand-alone document.

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

The current reporting regime has developed incrementally and not necessarily in a coherent fashion with the result that reports can lacks focus and contain too much immaterial detail or clutter. There may be some merit in rationalising this by setting high level principles. However this runs the risk of diluting the expectation that companies should report on objectives, performance and risks which are relevant and material to their individual circumstances. We fear that setting prescriptive requirements in an attempt to make them relevant for all companies could result in them becoming too high level, and therefore not useful in making investment decisions.

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

We believe there is significant scope to present information in a more helpful way. Companies should take notice of shareholders' requirement for consistent and comparable information to assist them to make investment decisions. Reports should be structured in a way that makes them clear and concise so that readers can easily extract the information they need. This can extend to something as straightforward as providing a comprehensive index to the report.

We share the concern of the Accounting Standards Board (ASB) and the FRC about immaterial clutter which was well expressed in their review of narrative reporting and in "Rising to the Challenge" in October 2009. A possible approach to counter this may be to encourage companies to explain how they measure and record the materiality of issues of potential importance to the business.

We note that initiatives are underway to encourage briefer but relevant reporting and would draw attention to the Institute of Chartered Accountants of Scotland's paper on Making Corporate Reports Readable[1]. The paper seeks to demonstrate that it is possible to produce a corporate report in less than 30 pages which tells management's story of what is important by eliminating the boilerplate narrative and providing decision-useful information.

**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?**

As we understand it, the substantive differences between the OFR and the Enhanced Business Review are not great and the main divergence was the higher duty on the external auditor to report on whether the information in the OFR was consistent with the audited accounts and whether the OFR was inconsistent with any other information that came to light during the

[1] http://www.icas.org.uk/site/cms/download/AA/Making_Corporate_Reports_Readable.pdf

audit. As a result of the repeal of statutory OFR, the ASB's Reporting Standard 1 was reissued as Reporting Statement 1 (RS1) as voluntary guidance. We consider that regardless of whether the OFR is reinstated, it would be sensible for the ASB to review RS1 to ensure that it is still current.

We do not consider that a statutory reporting standard would necessarily improve the quality of reporting and fear it could lead to a tendency toward boilerplating which would not encourage companies to report on information that is relevant and material. Some degree of flexibility is helpful as it allows for the use of judgement. We consider that a revised RS1 could continue to serve as best practice guidance. We also note that the IASB will shortly publish its own guidance on management commentary which may well have a persuasive effect on the approach of companies to reporting.

In summary, we have some reservations about an overly prescriptive approach which could have unintended consequences and result in more, rather than less, legalistic boilerplate reporting through bare compliance with the letter than true compliance with the spirit. We hope that market led best practice will be sufficient but recognise that the authorities should keep a watching brief to ensure that that companies do not abuse such flexibility. In this regard, we welcome the expanded role of the FRC's Financial Reporting Review Panel to include narrative reporting and we hope that this is developed further.

**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**

1. **Is this information useful to you? How do you use it?**
2. **Could disclosure be improved?**
3. **Are there key issues which are missing? If so, please explain.**

The fifth bullet point appears to refer to conflicts of interest on which companies are already required by existing law to make some kind of disclosure on related party transactions and so on. This is clearly in the wider public interest as well in the best interests of shareholders. It is very much for companies to decide on how much to report on the remaining provisions highlighted in this question and this varies from company to company both in terms of the extent and quality of reporting.

We feel that the above list of issues is sufficiently comprehensive from the investor perspective. If properly applied, it will play a vital role in giving investors an understanding of a company and its forward strategies. However, in order to ensure reporting is effective and useful, companies should be encouraged to explain how they measure and record the materiality of issues to the business. We believe that the quality of reporting in some circumstances can also serve as an indicator of the quality of management.

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

We believe that companies are likely to benefit from guidance on reporting. This could be in the form of best practice examples or key performance indicators, such as those of the Global Reporting Initiative[2], or the DVDA/EFFAS KPIs for ESG[3]. We also draw attention to the International Corporate Governance Network's guidance on best practice reporting[4]. In any case, anything that is reported, and the way it is presented, needs to be relevant to the company and must relate back to its stated strategic objectives.

We also concur with the FRC's view that the linkage between the front and back ends of the annual report and accounts needs to be improved. In this regard we favour the concept of more joined up reporting and support the Prince of Wales' Accounting for Sustainability Trust's initiative to set up the International Integrated Reporting Committee (IIRC) which seeks to "create a globally accepted framework for accounting for sustainability: a framework which brings together financial, environmental, social and governance information in a clear, concise, consistent and comparable format"[5].

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

Whilst not entirely convinced of the merits of an advisory vote on the Business Review, we believe it has at least some superficial attractions and should be considered further as part of a range of options to encourage companies to report more effectively. The main potential benefit is that it could provide a clearer focus of accountability on reporting. It gives companies the flexibility to report in a way that is meaningful to their business, but it also allows shareholders to monitor those who are taking advantage of such flexibility by making inadequate disclosure.

We anticipate that other respondents will object that there is already an opportunity to vote on the report and accounts and that it is not clear what a vote against the Business Review would mean in practice. We recognise that for an advisory vote to be meaningful it would need to be accompanied by effective engagement to ensure the company understands the requirements of the shareholders and the reasons for an adverse vote. At best this could stimulate more meaningful engagement between investors and companies.

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

We welcome measures to publicise excellence in business reports in order to raise awareness as to what is considered to be best practice in reporting. We would draw particular attention to the ICSA/Hermes Transparency in Governance Awards now in their second year and which seek to reward transparency in reporting in several categories including strategy, risk remuneration and governance.

We also consider that may be scope for the FRC, through the work carried out by the FRRP, as part of its annual report on narrative reporting to highlighting a limited number of companies that report to a high standard.

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[2] http://www.globalreporting.org/Home
[3] http://www.dvfa.de/files/die_dvfa/kommissionen/non_financials/application/pdf/KPIs_ESG_FINAL.pdf
[4] http://www.icgn.org/files/icgn_main/pdfs/best_practice/buss_reporting/icgn_statement_&_guidance_on_non-financial_business_reporting.pdf "ICGN Statement and Guidance on Non-financial Business Reporting" published December 2008
[5] http://www.integratedreporting.org

We also wish to make the point that improved technology may well assist better reporting in the future. We note that XBRL is being rolled out by regulators in some jurisdictions and whilst it is not necessarily the full answer, there may be lessons to learn. Web-based technology is still developing and will enable companies to report more coherently whilst providing links to standing data elsewhere on their websites. Companies could perhaps be encouraged to make greater use of technology in reporting through some sort of prominent award for innovation possibly with BIS endorsement or possibly as a new category under the Queen's Awards for Enterprise.

**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; and**
- **the process by which directors' remuneration is decided?**

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

From our experience we would observe that the level of disclosure within remuneration reports, as with most other aspects of company reporting, varies from company to company.

The specific requirements set out in the regulations are in principle comprehensive and provide sufficient guidance and detail to ensure that the information *required* of companies allows shareholders to make informed voting decisions on the advisory vote that accompanies the Directors' Remuneration Report. However, we further observe that the interpretation of the requirements generates a variety of approaches to disclosure, not all of which allow an informed view to be reached by shareholders. In such circumstances, many shareholders will not support the accompanying vote on the remuneration report; a vote against or an abstention is often considered appropriate on the disclosure issue alone, given the importance of transparent and fulsome information.

On the specific areas for comment:

**Total remuneration paid and how it is made up**

The amount paid as basic salary in cash is a routine disclosure item for companies. However, there remains some uncertainty about the value of long term incentive awards at any one point in time. Given that these awards drive the variable compensation element of an overall remuneration package, it would be helpful if there was some way to provide values of the outstanding awards at any one point in time, (for example, at the year end) and then published in the Remuneration Report.

Such disclosure would serve two purposes: it would provide a better line of sight for shareholders on the value of outstanding awards; and it would allow participants of the plans a clearer understanding of the monetary value of their interests in outstanding awards. One of the key concerns that investors have is that long term incentive schemes may not necessarily be motivational precisely because they are too complicated and participants do not understand how much there is available to them. The greater the degree of opacity in a scheme, from the

view of both participants and shareholders, the greater the extent to which the scheme will not achieve its ultimate aim: to align the interests of shareholders and directors.

As we stated in our response to the Walker Review in 2009, the US system of requiring disclosure of the top highest earners within a company, regardless of whether they are board members, would also be worth considering for the UK context, especially in relation to how the board sets remuneration levels for executive board members and how pay elsewhere in the company is taken into account when setting such levels.

A further area on which we would encourage specific requirements is salary increases. Too often, an increase in salary occurs without any specific disclosure in the remuneration report narrative. Shareholders do track such increases as they analyse remuneration reports year on year, but there should be a specific requirement for any % increase to be disclosed *and explained.* The importance of appropriate salary levels should not be underestimated, given that they are the driver for all other forms of the remuneration package.

**The performance criteria for payments to directors, and how these relate to the company's strategic objectives**

We very much agree with the Minister's observation in his foreword to the consultation document that it is "very important that there is a clear link between the company's strategic objectives and the criteria for payments to directors". The disclosure of the performance criteria applying to awards which generate payments to directors is fundamental to shareholders' understanding of how directors are incentivised to generate returns for shareholders.

Shareholders need to be able to assess the stringency of the performance criteria, in order to make a judgement about the linkage, or lack thereof, between pay levels and performance achieved. They also need to understand on what basis the performance criteria is being defined; ie. if it is an earnings-based performance criterion, what specific definition of the earnings metric is being used?

Unfortunately, in too many cases, the performance criteria is either not particularly stringent and challenging enough to justify the award levels available or there is not a clear enough linkage between the strategy that the Company is espousing, and the performance metrics that underpin the remuneration systems which shareholders assume drive the Executive Directors to deliver that strategy.

A mapping of the strategy drivers to the bases for performance metrics that underpin the remuneration system would, in too many cases, provide insufficient commonalities between either system, or indeed, none at all. This is where remuneration systems are lacking and we would encourage recommendations that require a narrative on how the specific performance criteria that is chosen underpin and drive the strategy of the company.

One obvious way in which this manifests itself is where the CEO and Finance Director provide forecasts in their quarterly update statements to the market, which indicate strong performance is expected and the performance criteria underpinning the remuneration system would be met easily. This apparent disconnect between what the market is being told and what is disclosed in the remuneration reports needs to be addressed and could be overcome by a more rounded discussion about pay, and specifically the performance criteria chosen, and how it underpins the strategic direction of the Company.

Following on from this, it is important to note here that the current disclosure requirements do include a requirement to explain as to why any such performance conditions are chosen. Some companies do take the time to explain why specific criteria is chosen; for example, that the metrics reflect the key performance indicators of the Company. However, this is by no means routine across all company disclosures and we consider that the disclosure requirements could be better enforced or indeed enhanced specifically to require a more detailed explanation of why specific targets are chosen in order that shareholders can better understand the linkage between performance criteria and strategy.

**Company performance against these criteria, so that there is a demonstrable link between pay and performance**

We consider that the requirements could be further strengthened to require a better explanation as to how the Company's overall performance is reflective of the achievement of the specific performance criteria within incentive plans.

Anodyne statements that assert "exceptional performance" during the year and that maximum bonuses were therefore payable do not provide sufficient information for shareholders to judge the link between pay levels and performance achieved. This could be achieved by an expectation of a better, more comprehensive narrative from companies about their remuneration programmes.

Exceptional performance can justify exceptional pay but the real question is whether performance is truly exceptional. The onus is on the Remuneration Committee to explain clearly the levels of performance achieved and essentially creating a narrative link between the financial statements and the remuneration system.

**The process by which directors' remuneration is decided**

We would emphasise that if there is enough information available, the process by which directors' remuneration is decided is apparent and clear to shareholders. However, in too many cases, we find explanations are insufficient to understand the linkage between pay and performance. In practice meaningful information is very rare on the process as to how remuneration is decided.

The role of the Remuneration Committee is critical to shareholders in terms of the explanations of the actions that they have taken during the year. We commend disclosures that set out at the beginning of the remuneration report what activities and decisions were undertaken during the year by the Remuneration Committee. We would draw particular attention to the 2009 remuneration report for Aviva plc as a good example of this type of disclosure. Such high level overviews should be encouraged across all companies so that shareholders have a clearer understanding of what they have focused on for the year under review.

We further consider that there should be a requirement for the discretion afforded the Remuneration Committee to be explained and when it is used, for there to be full and transparent disclosure of why this was considered appropriate, and what impact the use of their discretion had on payments made and the award levels achieved. Shareholders generally do not have a concern with discretion but too often, the discretion is used to the advantage of participants (ie. the vesting of awards despite performance criteria not being met) instead of to the advantage of shareholders (ie, the reduction in the level of award because the overall financial performance of the Company has suffered, despite specific performance criteria being met.)

In support of the above comments, we also submit a paper published by Railpen Investments and the UK proxy advisory firm Pensions & Investments Research Consultants (PIRC), entitled 'Say on Pay: Six Years On – Lessons from the UK experience'. The paper provides a comprehensive overview of the UK experience of having the annual Say on Pay vote, from the perspective of both companies and investors and analyses the impact of the introduction of the Directors' Remuneration Report Regulations in 2002. The key conclusions from the report are set out below and a copy is attached for reference:

- Both investors and companies report that since the introduction of the vote there has been an increase in engagement over remuneration. Whilst this has led to some friction, it has also created an improved dialogue between companies and their owners over this important governance issue.

- There has been a sharp reduction in directors' typical notice periods since the introduction of the shareholder vote. 75% of directors were on one year in 2001, compared to over 95% now. This has reduced the risk of payment for failure.

- Performance-related elements of remuneration now account for a much larger percentage of the total, with long-term incentive plans (LTIPs) becoming a more significant element.

- Between 2000 and 2008 there was a clear movement away from the use of option schemes towards LTIP share awards. And from 2003 onwards there was a small increase in the number of share matching (or bonus deferral schemes) being introduced, suggesting that following the introduction of the vote in 2003 companies were more innovative in considering their remuneration structure.

- But total remuneration has continued to grow even when markets have fallen, suggesting shareholders need to do more to achieve true performance linkage.

- Some shareholders do not appear to have used their voting rights effectively, with the average vote against a company's remuneration report falling from a peak in the 2004 season. Therefore the report argues that shareholders must use the ownership right of having a vote on pay actively if it is to have a meaningful effect.

**Potential Costs**

**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.**

As an investor rather than a preparer of accounts we have limited knowledge of the costs associated with reporting. Clearly companies are better placed to provide a thorough answer to this question. We will study responses on this with interest. We suspect that at least some of the information needed to support improved reporting would already be available for internal reporting and management purposes and so companies should not use cost alone as means for justifying inadequate reporting. However, we concede that a marginal increase in cost might be a price worth paying for better reporting and assurance.