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Ms Jane Leavens
Corporate Law & Governance Directorate
Department for Business Innovation and Skills
1 Victoria Street
London
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19 October 2010

By post and email to: Narrativereporting@bis.gsi.gov.uk

Dear Ms Leavens

# The Future of Narrative Reporting

## Introduction

1. Ernst & Young LLP welcomes the opportunity to comment on the Consultation Paper entitled *The future of narrative reporting* ('the Consultation Paper').

2. Ernst & Young is one of the largest global professional services organisations. We provide audit, accounting, tax, corporate finance and other business advisory services. Our UK activities are supervised by the Institute of Chartered Accountants in England & Wales (ICAEW), with further supervision over certain parts of our business by the Financial Reporting Council (FRC) and the Financial Services Authority.

3. In preparing this response, we consulted with others in the Ernst & Young network.

4. We have responded to the specific questions raised in the Consultation Paper in the attached consultation response form. We also set out in this covering letter some more general observations.

## Overall observations

5. We have long believed that high quality narrative reporting is an essential component if a company's annual report is to be helpful to and understandable by its shareholders. Its importance is further accentuated by the increase in the complexity of financial reporting, business models and business transactions engaged in by many companies. As such we were supportive of the proposal to introduce a statutory Operating and Financial Review (OFR) when we responded to the DTI in 2004. As the original OFR proposals suggested, narrative reporting should provide information to assist members to assess the strategies adopted by the entity and the potential for those strategies to be successful. We believe that the events of the recent financial crisis have served to further reinforce this need, especially the need for effective communication of the nature of a company's operations (sometimes articulated as its 'business model') and the risks it faces.

6. We should bear in mind that the enhanced business review reporting regime established by section 417 Companies Act 2006 is still relatively new and practice is evolving. We would also bring to BIS's attention that the Accounting Standards Board's (ASB) 2009 report *Rising to the Challenge*, identified an improvement in the quality of narrative reporting whilst commenting that there were significant opportunities for improvements in certain aspects (including risk reporting).

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7. The ASB also commented *"Preparing a good quality annual report that communicates effectively all the important information is a major intellectual and logistical challenge"*. It follows that good narrative reporting depends on those responsible being able to articulate clearly and effectively the 'view from the board room'. We are therefore not convinced that changing the statutory requirements at this point would necessarily lead to improved quality of reporting. Rather we would prefer to see companies being provided with greater assistance and incentives to improve quality.

8. The provision of further guidance and good illustrative examples should help drive such quality. However, we would not favour the provision of 'standard' key performance indicators (KPIs), as narrative reporting has to be specific to the entity concerned. There may also be a role for an award scheme. We recognise that many such schemes already exist but one sponsored and judged by BIS and the FRC would, we suspect, be highly influential. We expect that few companies would wish to be seen as performing poorly in such an assessment. Finally, in the light of the new Stewardship Code, we believe that increased involvement and challenge by shareholders, whereby they make clear to companies any shortcomings they identify with narrative reports will also drive improved quality without a need to change to statutory rules.

9. We perceive a certain tension implicit within the Consultation Paper as regards whether the focus on narrative reporting is on disclosing good quality relevant information to shareholders, or whether it is about enhancing social and environmental reporting to meet climate change and other policy objectives. The extent to which these are aligned will vary between companies. UK company law reflecting the requirements of the EU Modernisation Directive already requires quoted companies to include information on environmental, employees and social and community issues *"to the extent necessary for an understanding of the development, performance or position of the company/group's business"*. However, where such information is not included, this must be stated. It is interesting that *Rising to the Challenge* highlighted that this final requirement encouraged companies to add 'clutter' where such areas were not material to the business. Indeed it recommends that companies ***"Do** explain why CSR is important to the business ...**don't** include information on employees, environment and social and community that is not important"*. What is therefore critical is that directors establish an appropriate process to determine the level of relevance of such information.

10. In principle we see great merit in integrated reporting and as a firm we are closely engaged in the work of the International Integrated Reporting Committee and the Global Reporting Initiative. However until there is an agreed framework for integrated reporting (including environmental and social reporting) we think that BIS should consider very carefully what it mandates in relation to such reporting given the ASB's comment about 'clutter'.

11. One issue not explicitly addressed in the Consultation Paper is the extent to which auditors could provide greater assurance over narrative reporting. The original OFR proposals required auditors to disclose matters which had come to their attention during their audit which were inconsistent with the contents of the OFR. In our 2004 response letter we noted our concern about the potentially open ended nature of this requirement and the difficulty auditors might face in determining whether the directors had struck an appropriate balance of 'good' and 'bad' news in the OFR. Whilst these challenges still remain, and as recent debates following the financial crisis have shown we believe there is scope for auditors to provide greater assurance over narrative disclosures regarding a company's business model and the related risks; something which the FRC and EU are looking at. We welcome this. Such extended assurance would be complementary to enhanced disclosures by an audit committee about their work, their conclusions and the matters discussed with the auditor.

12. Turning to the question of the Directors' Remuneration Report we would note that for a quoted company there are multiple overlapping requirements arising from company law, accounting

standards and the Listing Rules and we would welcome efforts by BIS to rationalise these requirements. Notwithstanding that concern, our overall experience is that remuneration reports do contain much helpful information to enable shareholders to understand directors' pay. We do however accept that they can sometimes be impenetrable to the non-specialist reader. In our view any attempt to change the requirements must be based on a very clear understanding of the desired outcome. For example if the primary concern is that the linkage between pay and the strategy and success of the company is not clear, then there may be merit in splitting the current remuneration report and combining the narrative element currently in the Remuneration Report with the rest of a company's narrative reporting.

13. As BIS will be aware, wider debate is taking place both in the UK and internationally about how corporate reporting and auditing may be enhanced post the financial crisis. This includes initiatives by the House of Lords, the FRC, the ICAEW, the Institute of Chartered Accountants of Scotland and internationally the European Commission, the International Organization of Securities Commissions and the International Accounting Standards Board. While we commend BIS for raising the specific issue, we believe it has an even more important part to play in this wider review of corporate reporting. As such, we see this exercise as the start of a debate rather than the end of one.

14. BIS is also to be commended for taking a leadership role in this area. As it develops its thinking BIS needs to be mindful that big business is global. Accordingly, improvements to corporate reporting need to be internationally consistent, which should include the adoption of a single set of high quality global financial reporting standards.

15. We are grateful to BIS for publishing the Consultation Paper. We hope you find these observations and the responses to your specific questions helpful.

16. For the avoidance of doubt, none of the comments set out in this letter are intended to be confidential.

Yours sincerely

Ernst & Young LLP

Ernst & Young LLP

Attachment:
BIS consultation response form

BIS | Department for Business Innovation & Skills

**BIS consultation response form: The Future of Narrative Reporting**

**Name: Robert Overend**

**Organisation: Ernst & Young LLP**

**Address: Becket House, 1 Lambeth Palace Road, London, SE1 7EU**

**Emai**

**Return completed forms to:**
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Tel: 020 7215 1686
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**Please tick the box from the following list of options that best describes you:**

| | |
|---|---|
| | **Quoted company** |
| | **Other company** |
| | **Investor or investment manager** |
| | **Business representative organisation** |
| | **Investor representative organisation** |
| | **Non governmental organisation (NGO)** |
| | **Trade Union** |
| X | **Lawyer or accountant** |
| | **Other (e.g. consultant or private individual)** |

## Value of narrative reporting

**Question 1: Are company directors providing useful and relevant information on the company's:**
**i) forward-looking strategy and**
**ii) principal risks and opportunities?**

| Comments |
| --- |
| As auditors we read the narrative reports of both our own clients and other companies. Overall we believe that the quality of narrative reporting, particularly in relation to the two aspects highlighted in this question is variable, a conclusion very much consistent with the Accounting Standards Board's (ASB) report *Rising to the Challenge*. We believe that descriptions of principal risks and opportunities have been improving, in part as companies develop experience of reporting under section 417 Companies Act 2006 and also in part no doubt due to the observations on narrative reporting from the ASB and the Financial Reporting Review Panel (FRRP). However we recognise that there are still instances of what look like boiler plate disclosure which are not specific to a company/group. The discussion of forward-looking strategy remains an area where we believe many companies struggle. |

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

| Comments |
| --- |
| As auditors we have only limited insights on this question. We suspect that concerns about confidentiality, commercial sensitivity and about directors' liability still play a part in constraining what is included in relation to forward-looking strategies. They may also prompt the tendency towards all inclusive lists of risks and uncertainties, rather than on *principal* risks and uncertainties (with a focus on their likelihood and/or severity on the business). However as the ASB noted *"Preparing a good quality annual report that communicates effectively all the important information is a major intellectual and logistical challenge"*. Accordingly we suspect that some of the differences in quality noted between companies ultimately come down to the importance placed on such reports within each organisation (and hence the resource dedicated and the process used to draft the reports) and the different abilities of those involved in writing the reports. |

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

| Comments |
| --- |
| In general we believe that companies recognise the importance of reflecting the directors' view in narrative reporting. However we note that the constraints already discussed in the response to question 2 may occasionally lead to a generic articulation of these board level issues. The FRRP in its Annual Report 2010 has recently focused on the need for the business review of all companies (not just quoted companies) to include an explanation of the business model. This may lead to a fresh focus on narrative reporting by all companies and an improved coherence between the measures reported with the business model and those articulated in the board room. |

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

| Comments |
| --- |
| We believe that other respondents will be better placed to answer specifically to this question. |

**Question 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?**

| Comments |
| --- |
| We believe that this question is addressed to shareholders, but we set out a view from an auditor's perspective. Our duties and reporting responsibilities as auditors in relation to the directors' report, directors' remuneration report and certain corporate governance disclosures are set out in company law and the Listing Rules. We perform the work specified by auditing standards (and follow the guidance in the related bulletins). If we are unable to obtain the information required, clearly this is raised with management in the first instance, (and where relevant the audit committee). Our Firm also has structures and policies (eg required consultation within the Firm) to support audit teams which are faced with this situation, and ultimately the lack of information from a client will be considered as an input into client continuance decisions. |

**Question 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)?**

| Comments |
| --- |
| We have limited insights into the relative importance that shareholders place on narrative reporting in the annual report as opposed to the other sources of information available to them. |

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

| Comments |
| --- |
| The scope to simplify the requirements on which companies report is limited in part by the need to comply with requirements of European Directives such as The Takeovers Directive and the Accounts Modernisation Directive. However, we are aware of two areas of concern about current narrative reporting; a tendency for there to be duplication within reports and also that narrative reports may be cluttered by non-key issues. In any reconsideration of the regulatory requirements we believe that BIS should seek to ensure that nothing in the requirements encourages such disclosure.<br>We also refer to paragraph 12 of our covering letter regarding the need to rationalise the various source requirements (sometimes overlapping) related to disclosure of directors' remuneration. |

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

| Comments |
| --- |
| The current requirements provide for considerable flexibility (with use of appropriate cross-referencing in order to meet statutory requirements) as to how narrative reporting is presented. We do not think a 'one-size fits all' approach to arranging information would achieve better quality of narrative reporting, and strongly support the continuation of the current flexibility used as it enables companies to adopt the approach which they believe to be most appropriate for their circumstances. |

**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 |
| --- |
| No. We do not see value in reinstating elements of the OFR and do not feel a statutory reporting standard would help improve the quality of narrative reporting. The appendix to the Consultation Paper highlights the extent to which the original proposed requirements of the statutory OFR and those of section 417 Companies Act 2006 are similar. For this reason and the need for the section 417 requirements to bed down (see paragraphs 6-7 of our covering letter), as well as the fact that good quality narrative reporting depends to a large extent on the ability of those responsible to articulate the 'view from board room', we do not favour the re-introduction of the statutory OFR at this point.<br><br>However we note that the original proposals for the statutory OFR would have required a greater level of audit assurance than is provided by the current requirements of the Companies Act 2006. Given the recent debates emanating from the financial crisis on whether and how the audit and the auditor's report may be enhanced to provide assurance over narrative disclosures regarding a company's business model and the related risks, we would welcome a further consultation by the FRC and/or the BIS on this issue. We believe that there is scope for the auditor to provide greater assurance over narrative reporting as such assurance together with the involvement of audit committees, non-executive directors and internal audit, would lead to increased accountability of preparers to shareholders. |

**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 |
| --- |
| In our view the regulatory requirements set out an appropriate framework for the drafting of narrative reporting. As discussed in the response to question 1 we believe there is scope for improvements in the quality of disclosure. The response to question 11 suggests how this could be encouraged. |

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

| Comments |
| --- |
| Yes. We believe that more guidance to assist directors in the preparation of their narrative reporting would be useful. Such guidance could include the following:<br>• specific guidance on the process companies should go through to prepare the Business Review including who should be involved in drafting narrative reports; |

disclosing information "to the extent necessary"; and the importance of the link between board room discussions and the disclosures made.

- an extension of the guidance/observations already issued by the FRRP and the ASB focusing on how companies have responded to the earlier observations and specific extracts of good and poor practice especially of companies which have clearly explained their business model.

However we would not favour the identification of standard or sample KPIs as we believe that there is a risk that companies for which such KPIs were not relevant would nevertheless adopt them, adding to 'clutter' in their narrative reporting.

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

| Comments |
| --- |
| No. We believe that engagement by shareholders with directors on the quality of their narrative reporting is potentially a very important driver of improved quality. However we do not think that such engagement would be enhanced by an advisory vote on the Business Review. We believe shareholders have every opportunity to engage with the directors through current channels and of course going forward they will have increased opportunities to vote on director re-election. Adding a further advisory vote seems to add little further. |

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

| Comments |
| --- |
| Yes. We believe that there are a number of non-regulatory ways to improve the quality of narrative reporting as set out in our responses to questions 11 and 12. |

**Directors' Remuneration Report**

**Question 14: Do the current disclosure requirements provide clear and usable information about:**

- **the total remuneration paid to directors, and how this is made up;**
- **the performance criteria for payments to directors, and how these relate to the company's strategic objectives;**
- **company performance against these criteria, so that there is a demonstrable link between pay and performance.;**
- **the process by which directors' remuneration is decided?**

| Comments |
| --- |
| As stated in paragraph 12 of our covering letter, we believe that there is scope to rationalise overlapping requirements arising from company law, accounting standards and the Listing Rules.<br>As regards the specific question on whether the disclosure requirements result in clear and usable information, we accept that directors' remuneration reports can sometimes be impenetrable to the non-specialist reader. However before changing the requirements there must be a very clear understanding of the desired outcome. For example if the primary concern is that the linkage between pay and the strategy and success of the company is not clear, then there may be merit in splitting the current remuneration report and combining the narrative element currently in the remuneration report with the rest of a company's narrative reporting. |

**Costs**

**Question 15:**

**If you can provide any information on costs associated either with the existing narrative reporting requirements eg preparing your business review or your views on potential costs and benefits in relation to any of the ideas in this consultation, please give details.**

| Comments |
| --- |
| We believe that as preparers, companies are best placed to respond to this question. |