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19 October 2010

Dear Madam

**Consultation: The Future of Narrative Reporting**

We write in response to the invitation to comment on the Consultation.

Attached to this letter is the Department's response form which we have duly completed. Deloitte carries out an annual survey of narrative reporting by UK listed companies. Our 2010 survey "Swimming in words" is now available and we have been able to draw on these current findings in responding to this consultation. Overall, we have found that companies are producing high quality narrative reports. In particular, 93%, 94% and 90% of corporates provided respectively the required information about the environment, employees, and social and community issues. These percentages were a significant improvement on the 2009 equivalents.

In responding to this Consultation, we have also been able to draw on evidence obtained from our joint report, with the Association of Chartered Certified Accountants, published in September 2010. This research entitled "Hitting the notes, but what's the tune?" reports on an international survey of CFO's views on narrative reporting. What comes through strongly from that research is that more discretion and less regulation would be welcomed.

As we note in our response to Q15, UK annual reports have now broken the ton. The average length is 101 pages. Furthermore, there is no shortage of disclosure requirements and recommendations emanating from a variety of sources. We refer to this in our response to Q2.

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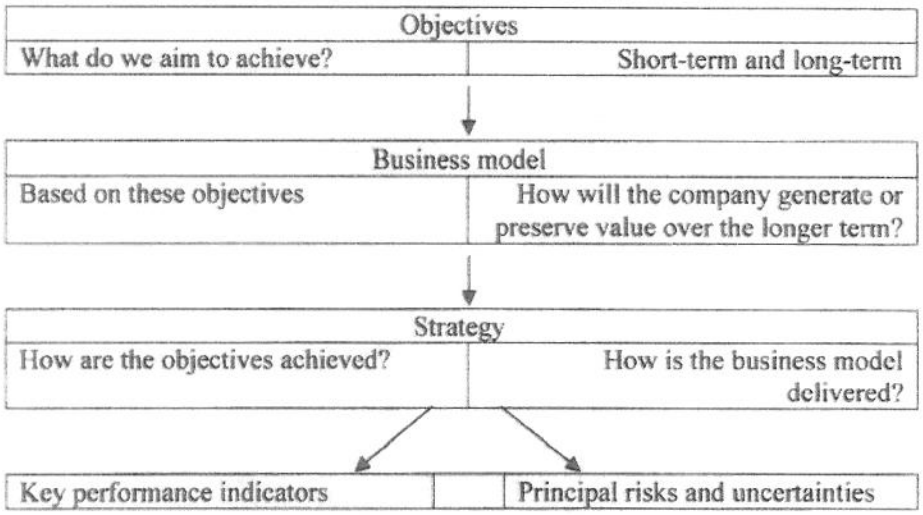
We welcome the Minister's three objectives for this Consultation. We believe that preparers and users would be served by a thorough review of the narrative reporting requirements at this time. As part of that review, we recommend that

- all the requirements emanate from one source;
- as far as practicable, the requirements are framed in terms of disclosure principles. In this regard, we draw attention to the nine matters set out in the 2010 Annual Report from the Financial Reporting Review Panel on what makes a good annual report; and
- the disclosure requirements are framed in a logical and coherent manner, based perhaps on the following chart.




We appreciate that such a fundamental review would be a major change from the practice of recent years which has been merely to add to the body of rules. We believe that a major shift is needed to achieve better, ie more meaningful, communication. As users participating in the ACCA/Deloitte research noted, they wanted "more, in fewer words". Information on the business model, that is what the business does and how it generates income, is needed. But, as a preparer participating in that survey noted "if you can't set this out on one side of paper, in fairly large type, then there's something wrong".

We would be delighted to discuss with you our views above and in the attached response.

Yours faithfully

Deloitte LLP

BIS | Department for Business Innovation & Skills

## Consultation response form: The Future of Narrative Reporting

A copy of the consultation available at: http://www.bis.gov.uk/consultations.

Responses to the Consultation MUST be received by 19 October 2010

**Name:** **Deloitte LLP**

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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** |
| √ | **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 uncertainties?**

**Comments**

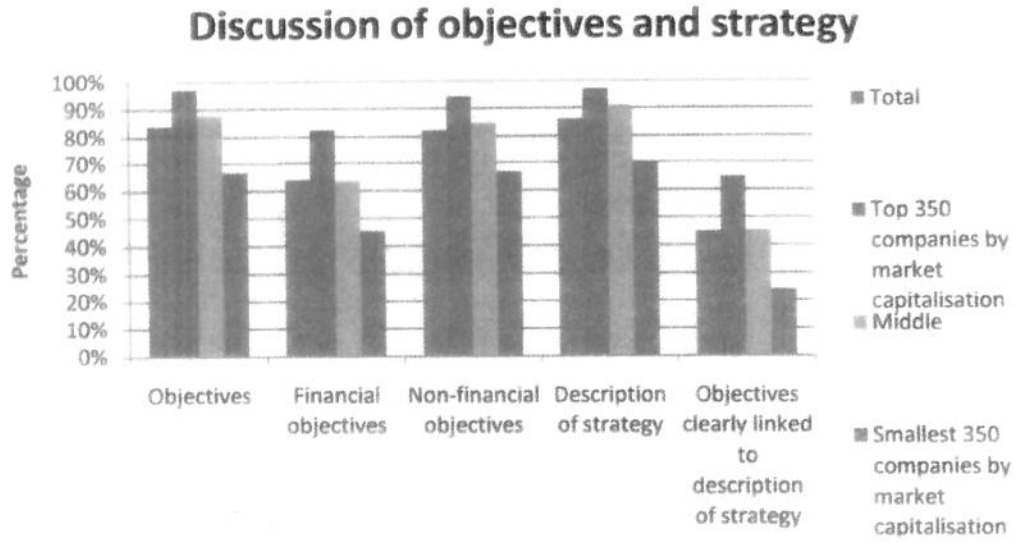
Deloitte's 2010 survey of narrative reporting found high levels of disclosures on both of these areas. The detailed findings follow.

Strategy and objectives

The Deloitte survey 'Swimming in words' demonstrated that performance has improved in this area. 84% of companies included a discussion of the objectives of the business in comparison with 79% of companies doing so last year. Only 3% of the top 350 companies sampled did not include such a discussion, as did 12% of the middle companies and a third of the smallest 350 companies.

The figure below shows the balance of discussion between financial and non-financial objectives and the attempts made by directors to describe the strategies employed to meet these objectives.

**Balance between financial and non-financial objectives and the links to strategies**




There was a good balance between financial and non-financial objectives, with a slight bias towards the disclosure of non-financial objectives such as those relating to market position or corporate responsibility. 82% of companies sampled included a description of non-financial objectives, compared with 64% of companies providing a discussion of financial objectives.

A large proportion of companies included a description of the strategies adopted to pursue these financial and non-financial goals. However, the nature and extent of these descriptions varied.

Only 45% of companies were considered to have provided a clear and meaningful description.

Risks and uncertainties

Overall, 95 of the 100 companies sampled clearly identified their principal risks and uncertainties. Of the remaining five companies, three were in the middle 350 category and two were in the smallest 350.

The overall average number of risks identified in both 2010 and 2009 was eight. On average, in both 2010 and 2009, the largest 350 companies identified eleven risks; the middle group identified an average of eight risks; and the smallest 350 averaged six risks.

96% of companies (2009: 91%) who clearly described their principal risks and uncertainties covered strategic, commercial and operational risks as well as financial risks. All of the top and middle 350 companies identifying principal risks covered all types of risks, while 87% of the smallest 350 companies discussed all types.

The common risks identified were categorised as follows.

- State of the economy – including the impact of the credit crunch.
- Operational issues – factors directly affecting operational output.
- Financial instrument (IFRS 7) risks – market, credit and liquidity risks.
- Regulation and legislation – including political risk abroad.
- Demand – specific factors affecting demand, including competition.
- People – loss of key personnel.
- Financing issues – factors directly affecting the company's ability to raise finance or meet loan covenants in the future.
- Foreign exchange – exposure to movements in foreign exchange rates.
- Legal action and litigation – uncertainty regarding outcome.
- Environmental issues – including natural disasters as well as CSR-type risks.
- Reputation and brand – loss of customer goodwill.
- Pensions – factors affecting pension contributions or liabilities.
- Cost of raw materials – movement in commodity prices or other direct costs of sales.
- Tax – including changes in tax rates and legislation.
- Research and development – including failure of R&D projects.

The state of the economy remains the most common risk identified, with 74% of those companies identifying principal risks and uncertainties identifying this as a principal risk. This is an increase in comparison with last year, where 63% of companies identified the state of the economy as a principal risk. Also in contrast to the prior year, this now appears to be a key risk across all three categories of company, with 76% of the top 350 (2009: 82%), 77% of the middle 350 (2009: 52%) and 68% of the smallest 350 companies (2009: 48%) identifying the state of the economy as a key risk.

The second most common risks were operational issues and IFRS 7 (financial instruments) risks, both of which were identified by 69% of those companies identifying principal risks and uncertainties. Most companies identified some sort of technological failure as being a significant risk to the company's ability to continue operations. The majority of companies also identified credit risk (to themselves or counterparties) as being a fundamental risk to the company's performance.

Regulation and legislation risks were the next most common risk, with 63% of those companies identifying principal risks and uncertainties identifying some kind of risk in this category. This was the most common risk category for the top 350 group of companies in 2010, with 82% of companies identifying a regulatory or legislative risk.

The survey has found that there has been a slight deterioration in the proportion of companies who attempted to describe their strategies for mitigating the principal risks and uncertainties they had identified (84% in comparison with 88% in the prior year).

In addition, a significant minority (18%) provided only generic descriptions of risks, with no discussion of why those risks were important specifically to the company. This was most prevalent in the smallest 350 companies, with 32% of the companies providing only generic descriptions. The top 350 companies performed better with only 6% of the companies providing generic risk descriptions, with 17% of middle companies doing so.

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

### Comments

Deloitte has published in September 2010 with ACCA an international survey on CFOs' views on narrative reporting entitled "Hitting the notes, but what's the tune?" 85% of UK respondents, compared to 71% on average, said that the biggest challenge in producing narrative disclosures was the sheer number of requirements.

The second highest scoring challenge was the cost and time involved in preparing the narrative disclosures. Narrative reporting (ie the front half of the annual report) forms 51% of the report which now averages 101 pages for all UK listed companies. While comments are made about accounting standards producing disclosure overloads, the narrative disclosures' requirements are also onerous. Furthermore, they emanate from a variety of sources including:

- various parts of the 2006 Companies Act;
- the UK Code on Corporate Governance and supporting guidance;
- the Disclosure and Transparency Rules of the UK Listing Authority;
- the Listing Rules;
- accounting standards such as IFRS7;
- FRC's "Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009"
- auditing standard ISA (UK and Ireland) 700; and
- non mandatory sources including the ASB's Reporting Statement on the Operating and Financial Review, the Climate Change Act 2008 and the 2010 Equality Act

The current reporting regime applying to UK listed companies can be described as dysfunctional. This clearly creates challenges for companies seeking to prepare a clear, comprehensive and cohesive understanding of the issues they face.

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

**Comments**

In our experience, the disclosures broadly reflect issues discussed in board meetings. For examples, directors will consider strategy and risks. In some respects the disclosures, such as those on remuneration and audit committees, are significantly more detailed than would typically be discussed at board level. These matters are delegated to board sub-committees and thus will not typically be issues discussed by the full board.

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

**Comments**

What comes through from the ACCA/Deloitte research referred to in Question 2 is that preparers are seeking to serve two masters simultaneously, namely to meet:

1. the legal and regulatory requirements; and
2. shareholders' requirements.

**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**

This question appears to be aimed at shareholders. That said, as auditors we challenge companies if sufficient or material information, of which we are aware, is omitted.

**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 confirm that we use many sources of company information including those listed above as well as press comments, research reports, agency analyses and so on.

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

| Comments |
| --- |
| We consider that there is considerable scope to reduce and simplify the narrative reporting requirements. Please see our covering letter. |

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

| Comments |
| --- |
| There is considerable scope to arrange the requirements in a more useful way to preparers. Please see our covering letter. |

## 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**

In the 2010 Deloitte survey, we found that 13% of companies surveyed included a statement entitled 'Operating and Financial Review' (OFR), which is in line with the results seen last year (2009: 13%). All except one of the companies identifying an OFR had also identified a business review. Of those companies identifying both a business review and an OFR, 92% included the OFR within their business review. The remaining 8% of companies did not include the OFR within the business review; instead, the OFR was a stand-alone statement within the narrative reporting.

Of the 13 companies choosing to present an OFR in 2010, only five (2009: four) made a statement regarding their compliance with the RS, with four companies (2009: three) stating full compliance with the RS guidance and one (2009: one) reporting some exceptions.

We do not see the value in reinstating elements of the OFR or introducing a statutory reporting standard alongside current legal requirements. Re the ASB's Statement, we note that the International Accounting Standards Board is expected to issue a similar statement at the end of October 2010. This will be called the Management Commentary.

However, as noted in our covering letter, we believe that there would be merit in initiating a fundamental review of narrative reporting requirements and recommendations.

**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

We comment below on current disclosure levels based on our survey findings.

94% of the companies surveyed made reference to trends and factors, likely to impact future performance of the company, within the business review (2009: 92%) as required by the Companies Act 2006. Of the six companies who did not include this information in the business review, four included such references elsewhere in the narrative. This represents an improvement in comparison with 2009, when only two out of eight of those companies failing to include future trends and factors in their business review included this information elsewhere in the front half of the financial statements.

General disclosures about the environment, employees and social and community issues have improved since last year.

**How many companies made disclosures about the environment, employees and social and community issues?**

| | 2010 | 2009 |
|---|---|---|
| **Environment** | 93% | 87% |
| **Employees** | 94% | 89% |
| **Social & community** | 90% | 70% |

Most companies chose to include these disclosures in a Corporate Social Responsibility (CSR) statement and formats varied from tabular or diagrammatic disclosures to sections of prose.

The Companies Act 2006 stipulates that information about persons with whom the company has contractual or other arrangements essential to the business of the company should be disclosed in the business review. 24% of companies (2009: 24%) included reference to contractual arrangements (either to disclose such arrangements or to state that there were none). Interestingly, compliance with this requirement has improved within the largest and smallest companies (44% and 15%, respectively, compared with 32% and 12% in 2009), at the expense of compliance within the middle group (12% of whom referred to contractual arrangements in 2010, compared with 27% in 2009).

The number of companies attempting to disclose their business model was low, by comparison. Overall, only 21% of companies made an attempt to describe their business model. 44% of the top 350 companies sampled referred to their business model, but only 15% of the middle group did so, and 3% of the smallest 350 companies included any reference or description.

A description of the business model was deemed, for the purposes of the analysis, to be more than just a simple discussion of what the company does. A reference to the specific way in which the company generates value or an explicit reference to "business model", together with a description of what the directors deem that model to be, was required to satisfy this requirement for the purposes of this survey.

**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**

In our view, there is considerable guidance available to companies. For example the ASB Reporting Statement provides sample KPI disclosures. Deloitte provides:

- its annual survey of narrative reporting which highlights good examples by named companies; and
- its annual book "iGAAP 2010: Financial statements for UK listed groups" which cover the requirements for the complete annual report.

Indeed, there is probably a surplus of guidance available to the UK companies.

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

**Comments**

We believe that this proposal would require further elaboration to determine whether it has merit. For example, is it to be an advisory vote on the company's performance in the year under the report? Is it a vote on the company's strategy for the future? At present, we do not seek any merit in a vote simply on the Business Review.

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

**Comments**

We comment on guidance in Question 11 above. We have also noted that we refer to good examples from practice in our annual surveys.

## 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

We consider that the current level of disclosure in directors' remuneration reports provides clear and helpful information to shareholders. Since the regulations were introduced in 2002 the quality of reporting has improved each year as best practice has evolved.

Last year saw a significant improvement in disclosures with most companies providing more information about both how remuneration arrangements for the coming year were being tailored to fit the circumstances of the company, and how remuneration in the year under review was linked to the performance for the year. This was driven by companies having to review and change remuneration arrangements in the context of a very challenging and uncertain economy and by increasing pressure from shareholders who want to see that remuneration is very clearly aligned to company strategy and performance, particularly when there is a downturn in company performance.

We would particularly caution against requiring any further disclosure relating to the total remuneration paid to directors. Current 'best practice' disclosure allows investors to assess the total level of remuneration that would be paid for maximum performance and the level that would be paid if 'on-target' performance were achieved. Including a total remuneration 'number' would add a significant level of complication in determining how some elements of the package are to be valued which would need to be consistently applied for all companies. In our view, the disclosure of such a number would fuel media interest and encourage pay comparisons and potential ratcheting rather than add any value to investors, as these numbers can be misleading and not necessarily comparable across companies.

While there are elements of the remuneration package, such as pensions and annual bonus, where no current specific disclosure on policy is required by the regulations, best practice has evolved such that very few companies do not provide some degree of information. Most of the FTSE 350 companies now include information relating to the performance criteria used in both short and long term incentive plans, how these relate to the company's strategic objectives. An increasing number of companies provide information demonstrating the link between pay and performance.

Over the past few years investors have increasingly demanded more and better quality information. This is set to continue with the introduction of the Stewardship Code which is likely to increase the level of shareholder engagement. We believe that increased communication between companies and shareholders is more likely to lead to transparent and useful disclosure which is tailored and appropriate to each company than the route of increased regulation which, in our view, tends to encourage boilerplate disclosure and more standardised arrangements.

## 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 noted in Question 2 above preparers' comments on the time and cost involved. We draw attention to the increase in the length of annual reports over the last 14 years, based on our research.

| Year | Average length of annual report (pages) |
|---|---|
| 1996 | 44 |
| 2000 | 56 |
| 2005 | 71 |
| 2006 | 85 |
| 2009 | 99 |
| 2010 | 101 |

**URN 10/1057RF**