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 by be received by 19 October 2010

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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

<u>Question 1</u>: Are company directors providing useful and relevant information on the company's:

i) forward-looking strategy and
ii) principal risks and opportunities?

Comments
We have received consistent feedback through our own recent consultation document "Making Corporate Reports Readable" (a copy of this document is enclosed for your consideration) that the current narrative reporting framework for corporate annual reports requires major improvement. Companies see the production of the annual report as an exercise in regulatory compliance. **Ideally, narrative reporting should provide the directors of a company with the opportunity to tell a cohesive story about the business that explains and enhances the financial information in the annual report. This should include an explanation of the business model, the key risks and areas of significant management judgement and the forward-looking prospects for the business.** **We believe that the corporate report should be addressed to the shareholder as the primary stakeholder. Where other stakeholders require the disclosure of information this should be done through a separate reporting medium, such as a separate report or throught the company's website. The current reporting framework is a confused clutter of regulatory requirements, which often require the same information to be disclosed several times.** **Recent ICAS research found that while users generally believe there is a value to narrative reporting provided in a company's annual report, its usefulness is currently limited by factors such as the use of standardised 'boilerplate' language and directors' fear of being held accountable for unrealised predictions. The disclosure of "principal" risks often results in the disclosure of every risk recorded on the company's risk register.** **The overall length and complexity of corporate annual reports are also barriers to the usefulness of narrative reporting. There are a number of factors contributing to this, including increasing regulatory requirements and increasing complexity in the underlying business model of many companies. The volume and level of detail in annual reports can obscure key business information, and it can be difficult to**

relate information in the narrative sections of the report to information in the financial statements. With preparers and users focusing on large volumes of highly-detailed, standardised disclosures, there is a danger that the bigger picture is missed.

<u>Question 2:</u> What are the constraints on companies providing information on these issues?

Comments

The starting point must be the need to "tell the story" of the business.

As stated above, two of the main constraints on companies providing this information are the complexity of the business model and the complexity and volume of regulatory reporting requirements. Often it is very difficult to identify these disclosure requirements when they are found in several pieces of legislation, regulations and guidance. This makes it difficult for management to exercise judgement in determining the key information to be presented in the narrative report.

There are a wide variety of user groups of a company's annual report with different and often competing information needs, therefore it is difficult for one report to meet all of these needs satisfactorily.

The usefulness of narrative reporting can also be constrained by the fear of litigation and other negative reactions in response to forward-looking or judgemental information provided. In particular companies are concerned about the reaction of the markets if they start to focus on only the key issues.

Companies are also concerned about the disclosure of commercially sensitive information. Some information they are happy to provide in one-to-one meetings with investors or even in the analyst presentation (which can often be found on the company's website) but they do not want to disclose this in the annual report. There is a belief that it is easier to explain the context through verbal communication – and therefore prevent an adverse reaction from the markets.

<u>Question 3:</u> Does the information provided reflect the issues discussed by the directors in board meetings?

Comments
We think it is unlikely that information provided in narrative reports reflects the issues discussed by the directors in board meetings. External reporting is likely to be less frank than informal discussions because of concerns about confidentiality and negative reaction to forward-looking information provided to the market. 'Safe harbours' in narrative reporting are considered to be vital to allow directors to provide a more frank discussion of key areas of judgement, particularly when these are forward looking. **There is also a disconnect between external financial reporting and internal management reporting: external financial information is prepared on a specific historical basis in order to comply with regulation and accounting standards, while different techniques are used to report internally on a more 'real-time' basis.**

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

Comments
In order to consider the needs of shareholders it is necessary to understand who the shareholders are. In the UK, many companies have a small number of institutional investors and some have no retail shareholders at all. Some shareholders are concerned only with making a short term gain, while others invest over considerably longer periods of time. These shareholders have different reporting needs. Retail shareholders may only need a high level general purpose document, while professional analyst will require significantly more detail. **The narrative information in an annual report is also only one element in a range of information used by shareholders to assess a company and challenge directors on key issues. As discussed above, the current reporting model does not make it easy for directors to communicate, or for shareholders to respond to, the key issues relating to strategy and risk.** **ICAS has recently published 'Making Corporate Reports Readable' – a proposal for a new short-form financial report which would replace the current annual review and summary financial statements. This model would require directors to tell a succinct and cohesive story about the company, explaining the business model, key risks and judgements, and demonstrating how these link to the financial statements. This short report would act as a 'road map', enabling shareholders and other users to access more detailed information if they require it.** **In the longer term we would envisage that the short form would replace the front half of the full annual report, with the detail being easily available from the company's website. The replacement of the annual review and summary financial statements would be a first step but would only benefit those companies who actually use the annual review and summary financial statements – normally those companies who have a large retail shareholder base.** **A copy of 'Making Corporate Reports Readable' has been sent with this response.**

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
It should be noted that the level of challenge to management also depends in part on the level of engagement by the investor and therefore there is a limit to the extent to which changes to communication by companies will impact upon this. **The volume of information currently provided means it can be difficult for users to assess what is the most important information and consequently undoubtedly affects the extent to which many shareholders are able to engage with a company.** **The short form report proposed by ICAS acts as a summary highlighting key areas which would allow users to investigate further as appropriate. A vital element of the short form report is that it would make clear the significant judgements that management has made – these are likely to be the types of issues that the external auditor reports to the audit committee, who have a key role in challenging management on behalf of the shareholders.**

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
Investors and analysts report that results announcements and presentations and meetings with management are amongst the most useful sources of company information. These are particularly valuable because of their timeliness and the opportunity to engage directly with the directors.

CSR reports are important for certain businesses and shareholders but not for all. It is important to remember that shareholders are not a homogenous group and therefore have differing information requirements.

Most companies now provide a considerable amount of information on their websites. The ICAS short form report model would involve regulatory information being provided on a company website. The short form report would be addressed to the shareholder.

<u>Question 7:</u> Is there scope to reduce or simplify the requirements on which companies report?

Comments
The short form report proposed by ICAS in 'Making Corporate Reports Readable' is a means of achieving this aim, by replacing the annual review and summary financial statements, and providing a roadmap to more detailed information that would be provided on the website. **This would only be the first step to reform as only some companies use the annual review and summary financial statements. We believe that the short form report could eventually replace the front half of the annual report.** **The short form report is developed on a principles basis and we would not proposed detailed guidance or prescribed formats. Instead we would envisage a greater role for the external auditor in the front half of the annual report (and therefore in the short form report). We envisage that the auditor could provide an overall assurance across the whole report, to a lower standard than the "true and fair" opinion given on the financial statements. This assurance could be in the form of a "balanced and reasonable" opinion or similar.** **It should be remembered that the main purpose of financial reporting is accountability and stewardship and is not to satisfy regulatory requirements – this information should be separate.**

<u>Question 8:</u> Is there scope to arrange the information in a more useful way?

Comments
The proposals in 'Making Corporate Reports Readable' achieve this by requiring a brief overview of the company and its business model, an explanation of the business model and the significant judgements made by the directors. This provides a cohesive view of the business and signposts users towards further information if it is required.

Business Review

<u>Question 9</u>: 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
We do not believe there is particular merit in looking at specific elements of the OFR, since this is unlikely to result in significant changes to narrative reporting. Rather, it is more important to look at the overall framework and consider how this can be improved. **A statutory reporting standard is preferable to non-mandatory guidance, but this must be principles-based with limited guidance, in order to prevent the development of yet more boiler-plate disclosure.**

<u>Question 10</u>: 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
This information will be useful for some companies and shareholders but not for others. There is a risk that these types of requirements result in 'boiler-plate' information being produced which does not help to tell the story about a business.

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

Comments
We believe that guidance should be kept to a minimum as detailed guidance, sample KPIs etc risk being used as a checklist, making it less likely that companies will consider their relevance or whether any alternatives could be more useful.

<u>Question 12:</u> Should there be a shareholder's advisory vote on the Business Review?

Comments
There is a risk that such a vote becomes purely procedural and therefore it is unlikely to have a significant impact. We believe it is more important to focus on improving the quality of the narrative reporting.

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

Comments

Non-regulatory solutions are unlikely to have a significant impact. Fears over litigation and market reaction will prevent companies from taking the initiative to improve their reporting without regulatory intervention. In addition regulation is one of the causes of the current problems with narrative reporting; therefore regulatory change will be required to make meaningful improvements.

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 believe there is merit in investigating whether the remuneration report should be removed from the annual report and filed separately with an appropriate regulator (as happens in the US where such reports are filed with the SEC). This would contribute to simplifying the annual report. Our short form report includes a high level remuneration report which provides the headline figures but we do not believe that the large volume of detail is necessary in the primary corporate report.

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
Not applicable

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