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Dear Jane

The Future of Narrative Reporting – A Consultation

We welcome the opportunity to respond to the Consultation Paper 'The Future of Narrative Reporting' and fully support the government's objective of driving up the quality of narrative reporting. We do, however, recognise that at some point the whole structure of corporate reporting – interim management reports, half year reports, preliminary announcements, analysts' briefings, corporate responsibility/sustainability reports and shareholder meetings – as well as the annual report itself needs looking at to ensure each bit is playing its part as best it can. The work of the International Integrated Reporting Committee (IIRC) is relevant in this regard.

With specific regard to narrative reporting in the Annual Report and Accounts, we are supportive of the current regulatory framework and consider that the Companies Act – supported by the Listing Rules and the Accounting Standards Board's (ASB's) Reporting Statement *Operating and Financial Review* - provides an appropriate framework around which companies have the flexibility to develop their own communication style. When used properly, this framework should facilitate the preparation of a single, consistent narrative which incorporates the board's view of the significant risks and uncertainties facing the company and the strategy they have adopted – in effect, the 'corporate story' articulated with clarity and cohesiveness.

There are, however, a number of matters that, if left unchecked, can impair the communication of the 'corporate story'. These include:

- The piecemeal growth in narrative reporting requirements which has led some companies to 'bolt-on' new requirements to their existing disclosures and over time this has resulted in a disjointed report with the constituent parts distributed throughout the annual report.
- Internal responsibility for drafting shared between numerous individuals – each with their own agenda – can lead to duplication and a lack of focus.

- A perception, often misplaced, that some of the disclosures are seriously prejudicial to the interests of the company.
- Using the Annual Report and Accounts as a multi-function document designed to engage with a multitude of different stakeholders (including customers, employees and the wider community) can result in a loss of focus and a disproportionate amount of space devoted to marketing and non-material corporate responsibility/sustainability issues at the expense of clarity on those matters necessary to understand the development performance and position of the company.

Notwithstanding these barriers, significant efforts have been made by many companies in this area and there are already many examples of good disclosure. We also recognise that as the Business Review requirements are relatively new it will be inevitable that some companies are 'feeling their way' in determining the style, nature and extent of the disclosures they make as good practice in this area develops.

Nevertheless, we see plenty of scope to encourage better practice – as defined by the FRRP (see below) – by non-regulatory routes such as publicising good examples, award schemes, league tables and strong encouragement and support for those business that 'tell their own story in their own way'. BIS, the FRC, investors, preparers and auditors all have their own part to play in this regard.

We do not, however, believe incre ased regulation (including a mandatory OFR Reporting Standard) is the right approach; indeed, increased regulation may well lead to increasingly generic 'boiler plate' disclosure which would be detrimental to the interests of shareholders and other stakeholders.

Publicising good examples

While we believe that there are already many examples of good disclosure, it is not always easy for preparers – who may have limited experience in reviewing narrative reporting statements – to determine what good looks like.

We note the good work done by various groups in some 'focused' areas of narrative reporting and the role 'good examples' can play in encouraging high standards of disclosure. In particular we highlight the ICSA's annual publication '*Board Performance Evaluation - Review of the annual reports of the FTSE 200 companies*' which in our opinion has been instrumental in improving disclosure of both board evaluation practices and the output of the evaluation process itself.

Given the FRRP already address the Business Review as part of their review work; it might be possible for them to compile a short publication of what they consider to be good examples of narrative reporting. There is a danger that the publication of 'good examples' by an authoritative body might lead to 'boiler plate' disclosure but, on balance, we believe that if enough good examples are given the advantages will outweigh the disadvantages.

Awards

Hand in hand with the publication of good examples we see a role for annual awards as a mechanism to recognise best practice in narrative reporting. Awards are already used to recognise best practice in annual reporting, corporate governance and other matters, so it seems logical to extend this mechanism to narrative reporting. This could be achieved either by giving appropriate weight to good narrative reporting in existing award schemes or through some new dedicated awards. In either case some sort of BIS sponsorship or support would add authority and, in our opinion, increase the effectiveness of such mechanisms.

League tables

As part of their review work, the FRRP (or other authoritative body such as BIS) could produce some sort of narrative reporting league table for (say) the FTSE top 250. Such league tables could be used to harness companies' competitive spirit to drive up reporting quality – or at the very least encourage those towards the bottom of the league to consider how they might improve.

Given the judgemental nature of narrative reporting it might not be possible to create precise league tables, but it should be possible to place companies into 'rough' quartiles.

Whilst the high-level banding information could be made available to the public; more detailed information could be shared with those charged with governance at each company on a private basis – if the FRC/FRRP considered it sensible.

Clarity, conciseness and focus

Over recent years Annual Reports have increasingly been used multi-function documents designed to engage with a multitude of different stakeholders - including customers, employees and the wider community; rather than - consistent with directors' duties – as a means to help shareholders assess how the directors have performed their duty to promote the success of the company for the benefit of its members as a whole. In some cases, this has resulted in lengthy complex reports and a loss of focus on that information - both financial and non-financial - that is necessary to present a fair review of the development performance and position of the company.

It is important to note that the information boards are now required to disclose within their 'fair review' of the business including both financial information *and* that environmental, employee and social and community information necessary for an understanding of the development, performance and position of a company - as well as that information specifically required for broader societal reasons such as 'carbon' disclosure. We wholeheartedly support the extension of the basic EC requirements in this regard and consider the disclosure of material non-financial information - including that relating to corporate responsibility/sustainability – a vital component of the information shareholders require in order to assess how the directors have performed their duty to promote the success of the company.

However, notwithstanding the importance of corporate responsibility/sustainability disclosure – which will vary by company, country and sector – the increasing trend towards multi-function documents has proved a significant barrier to the provision of high-quality narrative reporting and has perhaps had the unintended consequence of obscuring the financial and non-financial information essential to an understanding of the success of the business. As a consequence, we would support any initiative designed to limit the narrative reporting within the Annual Report and Accounts to a summary of the material is sues – with the proviso that more detailed supporting information is easily accessible (preferably via the company website) to those that desire it.

Whilst in no way wishing to undervalue the importance of more detailed and focused information to various stakeholder groups – or a company's wish to report certain information – additional environmental, social, community and employee matters that are sometimes currently addressed in the Annual Report and Accounts might be better suited to a dedicated self-contained document published outwith the Annual report. Other matters that are not tied to the reporting cycle may also be better addressed elsewhere thus relieving the burden on the year end reporting process.

Overall the balance should be for clear, concise, consistent and comparable information and, where appropriate integrated financial and non-financial information.

Financial Reporting Review Panel

We are also appreciative of the significant progress made by regulators in recent years and we see the extension of the FRC's remit to include aspects of narrative reporting as particularly important in providing an incentive for companies to make every effort to improve their reports whilst not acting as a deterrent against those companies seeking to present information in more innovative ways. The first results of the FRRP's work were seen during their most recent review cycle and we support their conclusions set out in their 2010 annual report. We also support the nine characteristics of good reporting set out in that same report and believe these are especially apposite when considering what good narrative reporting might look like. These are summarised below:

A single story - The narrative in the front end is consistent with the back end accounting information; significant points in the financial statements being explained in the narrative reports so that there are no surprises hidden in the accounts.

How the money is made - The business review gives a clear and balanced account which includes an explanation of the company's business model and the salient features of the company's performance and position, good and bad.

What worries the Board - The risks and uncertainties described in the business review are genuinely the principal risks and uncertainties that the Board are concerned about. The descriptions are sufficiently specific that the reader can understand why they are important to the company. The links to accounting estimates and judgements are clear.

Consistency - Highlighted or adjusted figures, key performance indicators (KPIs) and non - GAAP measures referred to in the business review are clearly reconciled to main heading figures in the accounts and any adjustments are clearly explained, together with the reasons why they are being made.

Cut the Clutter - Important messages, policies and transactions are highlighted and supported with relevant context and are not obscured by immaterial detail. Cross - referencing is used effectively; repetition is avoided.

Clarity - The language used is precise and explains complex accounting and reporting issues clearly; jargon and boiler - plate are avoided.

Summarise - Items are reported at an appropriate level of aggregation and tables of reconciliations are supported by, and consistent with, the accompanying narrative.

Explain change - Significant changes from the prior period, whether matters of policy or presentation, are properly explained.

True and fair - The spirit as well as the letter of the requirements is followed.

We recognise the difficulties faced by the FRRP when reviewing narrative reporting – the inherent judgement involved in the disclosures together with the desire for the board to report what it feels is important makes the Panel's role particularly problematic. However, we do think that FRRP play an important role in driving up the quality of narrative reporting and we value the role they play in this area.

* * *

Our comments on the specific questions raised in the Consutation Paper are set out in the Appendix. We hope that our comments prove to be useful and we would welcome an on-going dialogue. Please do not hesitate to contact me should you wish to discuss any of the points raised in this response.

Yours Sincerely

John Griffith-Jones
Joint Chairman
KPMG Europe LLP

Appendix - Specific questions raised in the Consultation Paper

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

i) forward-looking strategy and

ii) principal risks and uncertainties?

We believe that significant progress that has been made in recent years in improving the quality of narrative reporting underpinned by the Business Review requirements of the 2006 Companies Act and the extension of the FRRP's remit to its review. Nevertheless, as many of the requirements are relatively new it is inevitable that some companies are 'feeling their way' in determining the style, nature and extent of the disclosures they make; and in certain cases improvements could be made.

Specifically we note that the latest 'requirement'- the UK Corporate Governance Code provision recommending disclosure of the basis on which the company generates or preserves value over the longer term (the business model) and the strategy for delivering the objectives of the company – is applicable only for periods beginning on or after 29 June 2010 which serves to demonstrate that practice will continue to develop for some time to come.

However, notwithstanding the good disclosure provided by many companies, we agree with the FRRP's recent conclusions that some companies are not clear as to their principal risks and uncertainties or provide bullet point lists without the description needed in order for them to be fully understood. Others disclose a litany of possible risks that they, or indeed any company, might face but without indicating which are the principal risks or saying why they are important to the company.

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

We believe that it is important for the annual report to articulate a single, consistent narrative, which would incorporate management's view of the risks and uncertainties facing the company and the strategy they have adopted – in effect, the 'corporate story'. There are, however, a number of matters that, if left unchecked, can impair the communication of the 'corporate story'. These include those matters set out in our covering letter and, to a limited extent, a lack of clarity with respect to the requirements. One such example being the subjectivity in relation to the requirement to disclose information about persons with whom the company has contractual or other arrangements which are essential to the business of the company (Section 417, CA 2006).

Lastly, management (like all others involved in the capital markets) encounter difficulties in identifying risks that may be caused by 'discontinuities' in the business environment. This coupled with the fear of litigation if something is missed is another factor leading to 'blanket' lists of risk and uncertainty. If management are to be encouraged to provide the clarity and focus required by the Act, there needs to be greater acceptance of the difficulties

involved in identifying risks caused by 'discontinuities' and greater confidence in the effectiveness of the safe harbour provisions provided by s463 of the Companies Act.

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

Preparers of Annual Reports and Accounts are better placed to answer this question though we think the pertinent issue is whether the information provided is a fair reflection of what directors believe to be the key risks and other matters in relation to the company rather than the extent to which they were actually discussed at board meetings.

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

We are not convinced that the aim of the Annual Report and Accounts is to help shareholders 'press directors on key issues relating to strategy and risk, or to inform their business decisions'; rather it is to provide information about financial position at the balance sheet date and performance over the period under review – and by doing so facilitate an assessment by investors of management's stewardship of the resources under its control. As such, the Annual Report is in the most part a confirmatory document published some time after the completion of the events to which it relates.

Nevertheless, we are adamant that the Annual report should articulate a single consistent narrative which incorporates management's view of the risks and uncertainties facing the company and the strategy they have adopted – and in this respect the Annual Report does have an important role in informing investment decisions and is, in our view, reasonably effective in this.

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?

Investors and their representatives are better placed to answer this question. Nevertheless, we acknowledge the recent work undertaken by the FRC to improve the engagement between companies and their shareholders through the introduction of the UK Corporate Governance Code and the UK Stewardship Code.

We also note that quoted companies have an obligation under the FSA's Disclosure and Transparency Rules to disclose any information they hold that is likely to have a significant effect on the share price. Furthermore, auditors are required to state in their report whether in their opinion the information given in the directors' report (which includes the Business Review) is consistent with the audited accounts.

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 and their representatives are better placed to answer this question, but in our view corporate websites might be better employed as a means for disseminating some company information to investors and thus making the Annual Report and Accounts more accessible to readers. Website dissemination might be particularly useful for that information not directly tied into the financial reporting cycle and elements of corporate governance and remuneration disclosure.

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

We believe that the Business Review provisions within the Companies Act include a well-balanced list of disclosure requirements that are phrased in suitably high-level terms. Consequently we do not seek any radical changes to any of its provisions.

We note that there is some overlap between the Companies Act requirements in relation to the disclosure of directors' emoluments, and the requirements within the Listing Rules. Harmonisation between the two sets of requirements would be welcome – see our response to question 14.

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

As discussed in our covering letter, we would support any initiative to limit the narrative report within the Annual Report to a summary of the strategic issues with the more detailed supporting information presented in a separate document (preferably via a website) for those who desire that extra level of information.

Such a document may be particularly suited to the dissemination of (say) non-material environmental, social, community and employee matters that whilst interesting and important, are *not* necessary for an understanding of the development, performance or position of the company's business.

9. Looking at an Operating & Financial Review and the existing Business Review, 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?

With the exception of the requirement to state whether the review has been prepared in accordance with the relevant reporting standard (now the ASB Reporting Statement *Operating and Financial Review*), there is no material difference between 'old' Operating and Financial Review requirements and the existing Business Review requirements.

The existing ASB Reporting Statement (which currently provides good practice guidance) could be upgraded to a formal Reporting Standard but in our view this would only to add to the volume of existing regulatory requirements on narrative reporting and have little impact

in practice. There is even a risk that increasing prescription in this area could be met with generic 'boiler-plate' disclosure that adds no value for users of the financial statements.

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?

Investors and their representatives are better placed to answer this question, but in our view the current requirements strike an appropriate balance between regulation and the flexibility required for companies to disclose the issues they see as necessary to understand the development, performance and position of the company.

We accept that as a matter of public policy it is important for companies to report on a number of specific matters that might fall within these categories – for example the reporting requirements associated with the Climate Change Act 2008 – however we believe these should be introduced as and when required rather than by mandating a long list of generic matters to be included within the Business Review.

Finally, it is worth noting that the UK requirements go beyond the basic requirements set out in the EU Accounts Modernisation Directive and represent an example of where the UK leads Europe in terms of reporting.

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 the requirements surrounding the content of the Business Review are appropriate, however, there is scope for the proliferation of 'good practice disclosure' and limited changes to the ASB's Reporting Statement *'Operating and Financial Review'*. On this latter point, changing the title to *'Business Review'* and tying-in the guidance to the legal requirements would be helpful.

There is also room for the propagation of more detailed and focused guidance such as the Climate Change Reporting Framework produced by the Climate Disclosure Standards Board (CCSB). We do not believe such disclosure frameworks should take on quasi-mandatory status, as the ASB Reporting Standard is essentially fit for purpose in this regard, however

such guidance could be referred to in a compendium of other guidance appended to the ASB Reporting Statement.

We are particularly opposed to the publication of specimen key performance indicators, which in our opinion would simply encourage generic 'boiler-plate' disclosure.

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

We do not see a role for a shareholder advisory vote on the Business Review as there is already a shareholder vote on the Annual Report and Accounts.

We note that a vote is required on the remuneration report, but this is an area of particular significance to shareholders as it represents their opportunity to voice their opinion on the reward that the Directors have recommended for themselves. We do not believe this principle should be extended to other areas.

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

See covering letter.

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?

Overall, we believe that the directors' remuneration report (DRR) improved transparency in reporting directors' remuneration and has, through the introduction of an advisory vote, promoted dialogue between the boards and shareholders. Therefore, we do not think there is any need for a reform of the disclosure requirements of the DRR – though consideration might be given to requiring disclosure of only the key elements within the Annual Report and Accounts with the detail being disclosed separately on the corporate website.

However, the information given by companies in respect of directors' performance criteria, the company performance against the criteria and the process by which directors' remuneration is decided varies in quality between companies. In particular, how directors' performance criteria relate to the company's strategic objectives, and how the company's performance against that criteria demonstrates a link between the company's performance and the directors' reward are often poorly explained. In our view, the best approach to improving clarity in this area is through the development of best practice guidance and encouraging shareholders to take a more active role, rather than through further legislative steps.

We also have two specific comments on the DRR:

Quoted companies are currently required to comply with the disclosure requirements of the DRR and those of Schedule 5 to the Accounting Regulations (SI 2008/410). The aggregate information required by Schedule 5 is generally given in more detail by the auditable information of the DRR. In order to avoid duplicating these disclosures, many companies achieve compliance with the Schedule 5 requirements by cross referring the financial statements to the auditable part of DRR. This duplication of disclosure requirements seems unnecessary and could be avoided by removing the requirement for quoted companies to comply with Schedule 5. This may require some minor changes to the DRR requirements – eg, the requirement to give comparatives to the table of each director's emoluments and compensation – but would simply the disclosure regime.

Lastly, there are a number of minor differences between the disclosures required by the Listing Rules and the DRR. Although the FSA indicated its willingness in 2006 to align both requirements, these differences continue to exist. For example, LR 9.8.8 requires disclosure of the increase of transfer value of directors' excluding inflation, whilst the DRR requirement (2008/410, Sch 8, para 13 (2)(d)) requires the movement between transfer values - including inflation – to be disclosed. We recommend that the Government pursues this matter further with the FSA.