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THE FUTURE OF NARRATIVE REPORTING – A CONSULTATION

Response by F&C Investments

F&C Investments (F&C) is a London-based global asset management firm with institutional and retail clients collectively representing over £149 billion of assets[1]. We manage funds on behalf of insurance companies, institutional investors, pension funds and private individuals. Through our Responsible Engagement Overlay service (reo®) we have also been mandated to engage and/or vote on behalf of a number of insurers, pension funds and banks whose money is managed by other parties.

F&C supports moves to enhance narrative reporting as a mechanism for improving the quality of understanding and depth of dialogues between companies and their shareholders on the most important areas affecting corporate performance. We therefore welcome the opportunity to comment on the Department for Business, Innovation and Skills' consultation on the Future of Narrative Reporting.

Overview

F&C strongly supports constructive, high-quality engagement between institutional investors and companies and devotes substantial resource to company engagement. We use the company narrative report to gain an understanding of the company's business, its market position, strategy, performance, prospects, and how the board and management deal with risks that are both immediate and specific to these, as well as those that are of a broader, more systemic nature. We therefore use narrative reporting to inform our engagement with companies, including on environmental, social and governance issues.

F&C supported the introduction of the Operating and Financial Review (OFR) reporting requirements until it was repealed. We believe that OFR requirements would have added materially to the quality of disclosure available to shareholders, particularly as they applied to

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all UK-based quoted companies. While recognising that company reporting in the UK is often superior to that in other markets and that substantial improvements have been made in the past few years, we nevertheless would be supportive of the reinstatement of certain elements of the OFR and its original purpose to assist shareholders to assess the strategies adopted by the company and the potential for those strategies to succeed.

We agree that when producing narrative reports companies should have regard to the interests and information needs of both shareholders and other stakeholders in the company. In particular we note that the fiduciary duty of company directors as described in the Companies Act calls for appropriate regard for environmental and social factors that can have a material impact on a company's long-term performance. However, we also understand companies' concerns over an increasing reporting burden. We believe that effective reporting means making efficient use of various information delivery mechanisms (e.g. an annual report and accounts, other regular disclosures, such as a separate sustainability report, and the company's website) where each type is targeted to the specific needs of each audience.

In our view, the key to high-quality business reporting is not volume, but the materiality of the issues that are included in the Business Review (BR) or OFR. Companies should distil strategic goals and objectives, the drivers of and main challenges to performance, and key risks and opportunities (current and potential) for inclusion in the BR/OFR, thus making it more focused and tailored to the needs of shareholders. One area of particular challenge, but of increasingly recognised value to investors in the wake of the global financial crisis, is an assessment of the broader risks and value drivers that could affect the integrity of the business in particular, and/or the industry sector in which it operates more broadly. A discussion of secular trends in regulation, customer demand and public opinion and how this is expected to drive business performance should therefore be an important component of the BR/OFR. Additional information that the company considers important to communicate to stakeholders can be included under other sections of the annual report or provided in a separate report or on the company's website.

F&C is supportive of an advisory shareholder vote on the business review, provided the business review reporting requirements are enhanced to an OFR-equivalent standard and are equally applied to all UK-based quoted companies. We recognise that for such votes to deliver desired benefits, it will take time for companies to improve their reporting standards and for investors and their advisors to develop an effective framework for assessing the quality of business reviews. We would, therefore, recommend that the Department for Business, Innovation and Skills (BIS) issue a strong recommendation for companies voluntarily to put their BRs/OFRs to an advisory vote, and would suggest that BIS monitor progress in reporting standards over the next two reporting cycles, and reserve the right to compel the introduction of an advisory vote if, after such a transition period, insufficient improvements have been recorded.

Our detailed responses to the questions included in the consultation are provided below.

Consultation questions

1. Are company directors providing useful and relevant information on the company's:
   i. forward-looking strategy and
   ii. principal risks and uncertainties?

UK company reporting has improved over the last few years, but the quality of business reviews produced by companies varies significantly. In our experience, the improvements are more

pronounced in annual disclosures of larger and medium-sized companies (especially those whose activities are subject to a higher level of shareholder and stakeholder scrutiny) and less so in the disclosures of smaller issuers. While business reviews produced by companies are getting more informative there are three main areas where we believe improvements are needed:

1. Key gaps: While business reviews tend to provide a good description of the business and financial performance in the year under review, the following tend still to be inadequately covered:

    - Discussion of the market position of the business;
    - The main factors and trends affecting or likely to affect it;
    - The forward-looking strategy;
    - Performance against material non-financial indicators; and
    - Future prospects.

    We would especially like to emphasise the need for forward-looking reporting to avoid being "boiler-plate" if it is genuinely to deliver meaningful improvements. As such, it is vital for concerns regarding directors' personal liability be resolved satisfactorily through a safe harbour provision or treatment of equivalent effect.

2. Principal risks and uncertainties: While most annual reports contain some description of the principal risks and uncertainties facing the company, many companies fail to provide meaningful disclosure on measures taken to assess, monitor and mitigate identified risks.

    Furthermore, reporting tends to focus on existing risks, and there is little discussion of potential risks/opportunities that may arise from trends and developments in the macro environment, how they can affect the company's strategies and performance, or how well positioned the company is to deal with such risks.

3. Materiality: The issue of materiality is fundamental to the quality BR/OFR reporting. Currently, the tendency is to "clutter" BRs with large amounts of information and boiler-plate statements that add to the volume but not the value of narrative reports to shareholders.

    The issues covered in BRs/OFRs should be relevant and material to the company's performance; it should be clear how they are integrated into corporate strategy. Furthermore, the explanation of how the board defines what is material for the company and what the company's forward-looking time horizon is would add clarity to company reports.

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

N/A

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

We are unable to judge from current company disclosures whether the information provided reflects the issues discussed by the directors in board meetings. We would, however, welcome disclosures that give shareholders some insight into board discussions.

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

Quality narrative reporting does help shareholders to understand how directors are managing key issues relating to strategy and risk. It also helps shareholders to raise questions if they believe that material current/potential risks or opportunities are being overlooked by the board. Where the quality of reporting is poor, shareholder engagement would start from a lower level of seeking additional information or clarification from the company, thus making engagements more extended. We do believe that higher quality reporting would lead to more efficient engagement that focuses on questions of substance and strategic content rather than communication and transparency, which would be beneficial for both companies and shareholders.

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?

Where information provided by the company is inadequate, F&C would normally request additional information and engage the company to encourage it to improve future disclosure.

It would be helpful if BR/OFR reporting requirements were extended to equally cover all UK-based quoted companies. Provided the principle of relevance and materiality is applied by companies when producing a BR/OFR, we do not believe that this would create significant additional reporting requirements.

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)?

We use all available sources of company information, including the website, analysts' briefings, corporate social responsibility report and dialogue with the company. Different sources of company information are useful for different purposes. The value of a quality BR/OFR is in its strategic focus, the materiality of issues covered and its forward-looking perspective. Where shareholders or other company stakeholders need information on a specific aspect of a company's activities, they should be able to find additional disclosure under other sections of the annual report (e.g. more detailed reporting on governance, risk, environmental and social issues) in a separate report (e.g. stand-alone CSR report), or approach the company for additional disclosure. The company's website would be an appropriate place for all the standing information to avoid year-on-year repetitions in the annual report.

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

We do not think there is much scope to reduce or simplify current requirements for company's reporting. Moreover, the reinstatement of certain elements of the OFR would mean further enhancement of reporting requirements. However, we do believe that reporting should be proportionate to the size and complexity of the business and that the application of the principle of relevance and materiality would help to avoid an increase in the reporting burden for companies. We would encourage companies to make more active and innovative use of web-based reporting, which enables communication that is more tailored to individual user needs and can result in less cumbersome and costly reporting.

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

Companies could and should make their reports shorter, more meaningful and user-friendly by removing boiler-plate statements and using information delivery methods other than the BR/OFR to provide additional disclosure that may be of interest to a broader spectrum of company stakeholders. We do believe, however, that an appropriate cross-referencing in the BR/OFR is essential and would not only help shareholders and other stakeholders find additional information, but also provide assurance that the issues in question have been considered by the board and the management as a part of the company's strategic 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?

F&C supported the original OFR requirements and we continue to see value in certain elements of the OFR that were repealed. We do not believe, however, that a statutory reporting standard would help to improve the quality of reporting.

The specific areas where, in our opinion, the OFR reporting requirements would have added materially to the quality of disclosure available to shareholders include:

- Disclosure of the main trends and factors underlying the development, performance and position of the business of the company during the financial year along with the main trends and factors that are likely to affect the company's future development, performance and position. These disclosures should be prepared so as to assist shareholders to assess the strategies adopted by the company and the potential for those strategies to succeed.

  Where it is not happening already, this requirement should encourage boards to look at a broader range of trends and factors that may present risks and business opportunities for the company, as well as encourage shareholders and other stakeholders to engage the company where they believe certain significant risks/ opportunities may have escaped the board's attention.

- A statement of the business, objectives and strategies of the company; a description of the resources available to the company; and a description of the capital structure, the treasury policies and objectives and the liquidity of the company;

- Analysis of the extent to which the company's policies on environmental, employee and social issues have been successfully implemented. The disclosure of key performance indicators (KPIs) relating to these matters should be accompanied by disclosure of performance against these KPIs as well as targets for the following year and beyond.

Furthermore, we believe that OFR requirements should apply to all UK-based quoted companies consistent with the size and complexity of the business. Many small and medium-sized companies operate in high-impact sectors or emerging markets, which can expose them to significant non-financial risks. Investment in such companies carries higher risk and shareholders would benefit significantly from better disclosure. On the other hand, smaller companies should benefit from high-quality shareholder engagement prompted by improved disclosures. We therefore do not believe that smaller companies should be exempt from some

or all of BR/OFR reporting requirements, but rather should focus on issues that are material to their business to avoid creating a significant additional reporting burden.

We do not think that a statutory reporting standard would help to improve the quality of reporting for the following reasons:

1. A reporting standard, by definition, is bound to be overly rigid, and runs the risk of being overly weak in some instances and overly prescriptive in others. This would deny companies the flexibility to focus on issues that are considered material for their business and, consequently, would lead to more compliance-based boiler-plate reporting, which would not add value to shareholders or other stakeholders.

2. It would create onerous, and potentially unnecessary, reporting requirements for larger and smaller companies alike.

3. The appeal of refraining from a reporting standard is that it allows best practice to flourish by encouraging companies to tailor their reporting to the specific circumstances that affect their business, and to follow a course of continuous improvement rather than one of compliance.

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*

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

Unfortunately, very few companies report on the main trends and factors likely to affect the future development, performance and position of the company's business. We believe that all companies should provide this information as a part of the discussion of the company's business, objectives and strategies to enable shareholders to assess the potential for those strategies to succeed.

The information on environmental matters (including both the impact of the company on the environment and of environmental factors on the business), on employees, and on social and community issues can be a very important and useful part of the BR/OFR, but only to the extent that these issues are material to the company's business, performance and implementation of its strategies, as considered in both the near and long term. At the moment, many companies produce long backward-looking reports about their corporate social responsibility (CSR) activities instead of providing forward-looking strategic information about key environmental and social issues affecting their business. To be clear, many shareholders and stakeholders, including ourselves, would like to see more detailed disclosures in addition to key information under the BR/OFR; however, much of this information belongs more logically in other more detailed reports, provided they are appropriately cross-referenced in the BR/OFR.

F&C expects companies to report KPIs for all material financial and non-financial matters, including disclosure of actual performance against these KPIs for the year under review as well

as targets set for the following year and beyond. Some UK companies already report very well on this, but unfortunately they are small in number.

Disclosure on business ethics, including policies, systems and procedures employed to ensure ethical corporate behaviour is a key issue that is often missing from reports of UK companies. The risk arising from companies' failure to implement adequate and effective anti-corruption measures has increased significantly over the past few years and is likely to become even greater following the enactment of The UK Bribery Act. This makes reporting on the steps taken by the board and management to assess corruption risk and establish adequate processes and procedures for compliance with anti-corruption legislation an essential element of the business review reporting.

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

While some guidance is always helpful for both companies and investors alike, we do not believe there is a need for the government to create additional reporting guidance. Thus, some companies are already successfully using the ASB Reporting Statement as guidance; others may wish to apply the IFRS' "Management commentary" guidance. Moreover, there are surveys and examples of best reporting practices conducted and published by different organisations.

In our view, it is important to allow companies flexibility to report in a manner that they consider appropriate for the size and complexity of their business and consistent with statutory reporting requirements as well as the needs and expectations of their shareholders and other stakeholders. We are concerned that any actual or perceived need to follow a particular reporting guidance would lead to a tick-box approach, thus defeating the purpose of the BR/OFR and its value for shareholders. We believe that shareholder and stakeholder engagement with companies is the best way of ensuring continuous improvement of companies' reporting practices.

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

F&C is supportive of an advisory shareholder vote on the business review, provided the business review reporting requirements are enhanced to an OFR-equivalent standard, and the issue of selectivity is resolved as discussed below.

We believe an advisory shareholder vote on the business review could have many positive consequences, including:

- More rapid improvement in reporting standards through proactive mapping of shareholders' needs and expectations by companies;
- Empowerment of smaller investors, who are unlikely to engage companies directly;
- Elevation of the issues covered under the BR/OFR to the board level; and, most importantly,
- Greater consideration by the board and management of broader systemic, social, environmental and governance risk factors that have the potential to drive business performance, and a clearer articulation of how these are integrated into business strategy.

At the same time, we can see potential difficulties related to such a vote, including:

- Potential ambiguity on the meaning of the vote (e.g. non-support could indicate poor reporting, disagreement with the board's strategy or its failure to incorporate sustainability, etc.);
- Time and resource constraints of many investors and proxy voting service providers, which may lead to another tick-box exercise, thus defeating the purpose of the vote;
- Selectivity, insofar as current business review reporting requirements do not equally apply to all UK-based quoted companies. We see this as flawed insofar as many smaller companies present significant risks that merit the same or greater degree of attention, disclosure and shareholder accountability as that under consideration for larger companies.

In our view, the enhancement of the current reporting requirements and the application of these enhancements to all UK-based quoted companies (as we suggest in our response under question 9) are critical to the successful implementation of the shareholder advisory vote on the business review.

We also recognise that for such votes to be carried out thoughtfully and consistently, and thereby deliver the above benefits, it will take time for investors and their advisors to develop an effective framework for assessing the quality of business reviews.

We would therefore recommend that BIS issue a strong recommendation for companies voluntarily to put their BRs/OFRs to an advisory vote. This would allow companies that already produce an OFR-equivalent business review to get recognition for their superior reporting, and also serve as a catalyst for other companies to improve their reporting standards and engage in proactive dialogue with their shareholders and other stakeholders. We would also suggest that BIS monitor progress in reporting standards over the next two reporting cycles, and reserve the right to compel the introduction of an advisory vote if, after such a transition period, insufficient improvements have been recorded.

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

One non-regulatory solution would be to incorporate a recommendation for companies to provide comprehensive, forward-looking business reporting, consistent with the original OFR requirements, into the UK Corporate Governance Code. The "comply or explain" philosophy of the Code would allow companies flexibility to tailor their reporting to the needs of their shareholders and other stakeholders. Furthermore, the inclusion of such best practice recommendation into the Code would encourage UK-listed companies domiciled overseas to adopt this reporting framework on a "comply or explain" basis.

The introduction of the UK Stewardship Code should also be helpful in promoting better narrative reporting. The increase in shareholder engagement that is expected from the Code should result in a better understanding by companies of the information needs and expectations of their shareholders, thus leading to better reporting.

Finally, it would be helpful if the Financial Reporting Review Panel played a stronger role in monitoring company reporting and its compliance with the statutory reporting requirements.

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?*

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

The majority of UK companies produce adequate disclosure of the total remuneration paid to directors and how it is made up. In addition, some companies have started to disclose the expected value of share-based incentives granted in the year under review and include it within total remuneration. This is a helpful disclosure, as it gives investors a better idea of how much executives can expect to receive for meeting performance targets at each of several levels of difficulty.

Performance criteria linked to awards of variable remuneration to executive directors are typically disclosed for long-term incentive plans. The disclosure is less common in relation to annual incentive plans as companies cite commercial sensitivity of such information. The link between performance criteria and the company's strategic objectives is generally not clear from remuneration reports, with only a handful of issuers attempting to explain such a link. Furthermore, very few UK companies currently disclose actual performance achieved against performance targets for either long-term or annual incentive schemes, although we note that the number of companies providing this information is gradually increasing.

Remuneration reports usually contain a boiler-plate statement on the work of the board's remuneration committee; however, this does not cover the entire process, which typically involves significant input from the company's internal departments, the remuneration consultant(s) and executive directors before a final decision is made by the remuneration committee.

There has been a gradual improvement in the quality of remuneration reports produced by companies. The best way of improving remuneration reports, in our view, would be through shareholder engagement and inclusion of the recommendation on best practice remuneration reporting in the UK Corporate Governance Code.

For any further comments and questions please contact:

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