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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
X	**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
Environmental and social reporting is incredibly important in helping stakeholders assess companies' environmental and social performance. Unfortunately, environmental and social issues relevant to a company's strategy, risks and opportunities are currently not being reported adequately and constitute a major gap in directors' reporting. Many reports make vague statements relating to the seriousness of these issues to the company but there is a lack of transparency as to how such risks were identified and how directors have determined to manage them. This includes providing detailed and relevant information from a range of key issues and associated risks, combined with contextual information to clarify the choices made about which risk factors are highlighted. **Findings of The CORE Coalition** A recent report produced by The CORE Coalition[1] highlights how The Companies Act (2006) reporting requirements has failed to make environmental and social reporting simpler and more effective. Analysis of FTSE100 company reviews revealed: • 8% have no clearly identifiable business review, leading to confusion for shareholders and stakeholders alike. • 17% made no reference to environmental issues, despite wide acceptance that climate change is a business risk. • 8% completely failed to include any social issues in their business review. • 14% failed to include any social issues other than labour. **Lack of Compliance with the Spirit of the Requirements** CORE's report also found that compliance with The Companies Act is far from comprehensive, with many companies not acting in the spirit of the reporting requirement. The reporting of non-financial information in business reviews was highly inadequate. For example, not a single company mentioned adaptation to climate change and extractive companies were silent on known areas of human rights risk, such as security around facilities. Of significant concern was also apparent lack of compliance with s.417 which

[1] By Professor Adrian Henriques (April 2010) The Reporting of Non-financial Information in Annual Reports by the FTSE100 available at www.corporate-responsibility.org

requires that if a Business Review does not contain information about each of the specified key factors which underlie the business' performance, then these omissions should be stated. Although information in many reports was sparse, no declaration of this sort was found in any of the Annual Reports reviewed.

Quantitative information is critical in assessing business performance and although The Companies Act makes specific reference to the use of Key Performance Indicators (KPIs), CORE's study found few companies referred to KPIs in their reports. Furthermore, where quantitative information was reported, there was rarely any description or detailed specification of the indicators used. The most reported area of environmental information was 'emissions, effluent and waste', which includes CO_2 emissions; this information is often required by other regulation and so is more readily available. Yet even here, only one third of companies surveyed reported quantitative information and 18% did not mention the issue at all. CORE believe many environmental and social issues, such as CO_2 production and a company's susceptibility to climate change should be widely considered and reported constituting a 'principal risk and uncertainty facing companies' (Section 417 (3) (b)). While climate change was the single best-reported issue other than economic performance, detailed quantitative information was provided by only 48% of companies. In general it was surprising to find that there were almost no analyses of the sensitivity of the company to climate change or what adaptation measures the company was adopting.

Confusion Regarding Requirements

During the process of liaison with companies in order to complete the study, there was evidently considerable confusion among company secretaries and CSR departments as to what a Business Review actually is, and what it should contain. At its worst, in some cases, this meant that it was not possible to identify the Business Review: eight Annual Reports appeared to have no identifiable Business Review section. Where Business Reviews were easily identifiable, there was a variety of practices concerning the status and use of external sources of non-financial information. For example, some companies referred to more detail on their websites, others referred generally to their CSR reports, while yet others made reference to an internet location at which further detail could be found. According to legal advice obtained by CORE, such general references should not be considered a part of a Business Review.

Poor Quality of Information

s.417 of The Companies Act (2006) describes the purpose of the Business Review to 'help them assess how the directors have performed their duty [to promote the success of the company] under section 172'. Of significant value

[2] Details and documentation available here http://www.clientearth.org/testing-the-law-and-the-regulator

to making such an assessment would be information regarding the way the Business Review was prepared. Yet only a minority of companies included such information.

Furthermore, information is often of extremely poor quality. Most companies fail to provide consistent, robust and properly contextualised information about environmental and social risks. For example, climate change reporting is rarely quantitative, often inaccurate and rarely evidenced with links to how this data has informed decision making by the company. This is also true in other issue areas. ClientEarth's complaint to the Financial Reporting Review Panel (FRRP) regarding Rio Tinto's 2008 annual report[2], considers the failure to mention numerous specific material issues, including the decision of a major shareholder to divest on environmental grounds, and the reputational and litigation risks associated with specific mining projects.

Usefulness of Data: The Need for Standardised Measures
The absence of comparable, standardised measures means that companies who improve their environmental and social footprint are often unable to demonstrate their success relative to their industry peers (or their key stakeholders). Readers are often sceptical of the information provided, particularly where reporting consists of vague language and grandiose statements.

If companies report according to a common protocol, they will be able to demonstrate that they have used the appropriate process to assess risks, define boundaries, measure impact and report on them in a way that is meaningful, consistent and comparable. It is also currently not possible for investors and consumers to make sensible comparisons between companies. In relation to climate change, this lack of transparency undermines efforts to assess and then reduce the contribution of UK companies to national or international carbon emissions targets.

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

Comments

Poor Enforcement Mechanisms
Lack of enforcement of the existing Business Review requirements is a significant problem. The FRRP does not have sufficient resources to undertake this role and where FRRP may have taken action, what has actually occurred is unknown due to a lack of transparency in this process. The Government's recently announced cut in funding to the FRC, if it results in the reduction of funding and capacity of the FRRP, is of significant concern. Lack of independence due to the narrow make-up of FRRP members, is also

of concern. Furthermore, no legal cases have been launched by the FRRP, which would have provided clearer signals to companies about what is legally required and the need to comply with the law. This failure contributes to the perception that the Business Review is not a compliance issue.

Lack of Investor Engagement
Although many investors cite poor information as a barrier to greater engagement, it is also true that many investors do not demand better information or demonstrate sufficient concern about environmental and social impacts and risks. Reform to the existing regime, although it should empower investor engagement, must also recognise the reality of investors' disinterest in long term risks and much environmental and social information. If such disinterest endures there is a danger of increasing unmanaged risks and unmitigated detrimental environmental, social and financial impacts.

Assessment of Risk
Subjective assessment of risk results in significant environmental and social risks being dismissed by companies as being too remote or unquantifiable to be reported, such as carbon risk assessments. Guidance on what type of information and its format would make it easier for companies to assess what information should be included. Research has been undertaken in this area to provide the basis for such guidance, including a study carried out by the International Integrated Reporting Committee.

Proliferation of Reporting Standards
The plethora of competing reporting standards in key areas such as greenhouse gas (GHG) emissions can make it harder to report consistently and appropriately. Government guidance providing a definitive mandatory reporting standard could help quell this growing and unhelpful proliferation.

Lack of Clarity of the Law
One clear constraint is also the lack of clarity in the existing regulatory regime, and a lack of guidance as to what constitutes adequate reporting under the Companies Act 2006. Guidance would help companies to focus on providing relevant and useful information.

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

Comments
No Comment.

<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
Poor Quality of Information Preventing Meaningful Investor Engagement Company reporting must at a minimum provide readers with adequate information to identify key issues of concern in order that they can conduct their own analysis and press directors and management on their strategy and processes. This minimum standard is not currently being met. For example, a report by WWF-UK highlights the challenges shareholders have had in obtaining key information regarding tar sand investment by BP and Shell[3]. In relation to climate change, research undertaken by Fairpensions indicates that 86% of fund managers surveyed stated that they would welcome mandatory reporting requirements for companies to report their GHG emissions and 78% would welcome stock exchange listing rules requiring companies to disclose risks related to climate change[4]. More than half the respondents said that poor quality data on GHG emissions disclosed by firms and a lack of regulatory requirements for investee companies were barriers to incorporating climate risks and opportunities into their analysis and decision making. **Lack of Verification of Information** The lack of verification of information leads to considerable doubt as to the accuracy of the information provided. Many investors will find environmental and social reporting of minimal use until it is subject to the same standard of verification as financial information. Too often information glosses over critical environmental and social risks and problem areas, overemphasising achievements. Providing such a biased assessment is of minimal use.

<u>Question 5</u>: 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
Legislation Requiring Full Disclosure of Environmental & Social Impacts and Risks Existing levels of disclosure on these impacts and risks is currently highly inadequate. Even when it is disclosed in some form, the information is often presented in a confusing, unhelpful, incomplete, or inconsistent way and is extremely difficult and time-consuming to find. New legislation which would require such disclosure to be full, clear and comparable is essential in promoting greater and more effective engagement, as well as ensuring that

[3] "Toxic Fuels: Toxic Investments – why we need greenhouse gas reporting", WWF-UK and The Co-operative Bank, Insurance and Investments, 2010. Available at www.wwf.org.uk
[4] See Fairpensions http://www.fairpensions.org.uk/policy

directors are made accountable for company's social and environmental impacts.

Role of the Regulator
The regulator also has a key role to play as part of a system of incentives and disincentives for companies to provide information that is accurate and comprehensive. Where companies are not meeting their legal obligations, the regulator has an important role to play. A stronger, pro-active, more transparent and accountable regulator is an essential part of a more effective reporting framework. Not only would this ensure greater clarity in what constitutes adequate reporting, but it would also play a role in ratcheting up performance.

Shareholders are reluctant to use instruments at their disposal to challenge companies that fail to be transparent about their social and environmental risks. This may be partially due to existing instruments not being geared towards this purpose.

Use of Shareholder Resolutions
Many members of CORE have promoted shareholder resolutions as a way to encourage company transparency and prioritisation of environmental and social issues by the company directors. However the process of filing shareholder resolutions is extremely onerous, difficult to conduct and expensive.

Separate vote on The Business Review at AGM
A separate vote on environmental and social data provided by the company could help focus the minds of investors and directors alike on these issues.

<u>Question 6:</u> What other sources of company information do you use and how valuable are they (e.g. information provided on the website, analysts' briefings, and dialogue with the company, corporate social responsibility report)?

Comments
CORE's members access a range of sources of information regarding companies' activities including reports and accounts, websites, CSR reports and face-to-face meetings. While face-to-face dialogue can be useful, it is not a substitute for better reporting. The problem with relying unduly on face-to-face meetings is that companies can choose what information to provide to different categories of

investor and stakeholder. This may lead to the situation where companies communicate diverse and conflicting messages, depending on what is most expedient to communicate to a particular audience.

Markets rely on consistency of information to operate effectively. Allowing companies to selectively disclose information to different stakeholders is not consistent with the need to make vital information readily available to all interested parties. Other sources of information are not a substitute for comprehensive and transparent information that is in the public domain. At a minimum, stakeholders need access to enough information to decide which issue areas give cause for concern and further analysis or engagement. Much existing reporting does not come close to meeting this bare minimum.

It is important that information be disclosed in an effective, accessible, and coherent manner, which facilitates analysis of key issues, rather than confusing users and obscuring the links between inter-related factors. CSR reports, although sometimes of value, are generally a poor source of up to date, reliable and relevant information.

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

Comments
Streamlining of Standards There are currently a number of national and international standards for the reporting and disclosure and these should be streamlined under one clear and comprehensive mandatory framework.

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

Comments
Standardised Information Comparability is key to the usefulness of reporting for making business decisions. Consistency of presentation can be enhanced by providing standardised information and guidance, particularly through the use of Key Performance Indicators (KPIs) and explanation of their context and assumptions. A recent report produced by Harvard University provides guidance as to how this could be carried out[5].

[5] 'From Transparency to Performance: Industry-based Sustainability Reporting in Key Issues', Steve Lydenberg et al, Harvard University, June 2010 available here http://hausercenter.org/iri/wp-content/uploads/2010/05/IRI_Transparency-to-Performance.pdf

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
Many elements of the OFR would be useful to be reinstated. **The Enhanced Audit** This would be useful to address the lack of reliability of narrative reporting. As well as content, the audit should concern itself with the process the company has undertaken to produce its business review. **Future Risks & Developments** There is a need for the business review to also address future developments and risks to the company. This should include information regarding existing court cases and regulatory action relating to the company, including for example complaints to National Contact Points of the OECD Guidelines for Multinational Enterprises. Data should have an appropriate focus on strategic factors and risks, and on the way in which environmental and social factors affect them. **Comparable Information** A comparable framework for reporting of environmental and social issues outlining key matters is critical. This should include ecosystems impacts, water use, climate change impacts, community relations, relations with trade unions, human rights impacts and any other relevant environmental and social information that may be necessary to report in order to have a fair understanding of performance, any reputational risks, risks to the company's social licence to operate and any regulatory risks. A statutory reporting standard should be reintroduced and, unlike the OFR, its wording must ensure comprehensive assessment of these issues is included. In relation to GHG emissions, a clear, consistent, comparable definition of carbon disclosure is vital for progress towards UK climate change targets. A recent survey of 1,674 practitioners by the Institute of Environmental Management and Assessment finds that over 80% support GHG reporting becoming a mandatory requirement[6].

[6] Institute of Environmental Management and Assessment (September 2010) GHG Management and Reporting available on subscription here http://www.iema.net/logindownload?file_url=http://www.iema.net/download/environmentalist/Issue105-October-2010.pdf

<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
Disclosure could be improved by replacing generic statements on environmental and social impacts with a balanced and reliable assessment of key impacts and risks, consistent with financial reporting. Human rights should be referred to explicitly and not merely subsumed within other categories. This would be consistent with the recommendations to the UN Human Rights Council of the UN Special Representative on Business and Human Rights, Professor Ruggie. **Usefulness of Information** Existing environmental and social disclosure is often inconsistent and incomplete, lengthy, repetitive and confusing. An improved and more precise regulatory framework can help ensure concise and consistent disclosure which will be of much more use. **Clear Guidance Required** Disclosure could be improved by providing clear guidance on both the principles and the process of preparing narrative reports. This should include sector-specific guidance on factors to be covered, on how decisions should be made regarding applicability of data, and how to increase the usefulness of the information disclosed. Non-financial KPIs would be of significant value in this area. **Reliability** It is essential that the information in company reports is fair, balanced and comprehensive – statutory requirements must be in place to that effect, and these requirements must reflect objective standards. **Verification** Verification of the information in company reports, and of the process followed to generate this information, is essential to ensuring its reliability. The mandatory audit should be expanded, and steps must be taken to enhance its

comprehensiveness and scope. Much research undertaken in relation to social audits, illustrates the lack of reliability of these audits for verifying claims made by companies[7]. In order to be effective, there is a clear need for these audits be supplemented with interviews with key stakeholders including trade unions, local community representatives and relevant civil society actors.

Enforcement

Enforcement of the law is fundamental to the effectiveness of the law. The regulator responsible for monitoring and ensuring compliance with the law must do exactly this. This includes taking positive action to ensure legal requirements are met.

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
A statutory reporting standard should be introduced, with guidance to accompany it. Non--financial KPIs should be used to ensure that reporting is meaningful, useful and comparable. This should cover key matters relating to ecosystems impacts, water use, community relations, trade union engagement and respect for labour rights, climate change emissions and human rights impacts. General principles should also be provided, demonstrating the need for forward-looking, strategic, balanced and relevant information. It should also direct companies to an appropriate format to ensure comparability and conciseness. Although best practice examples are useful, given the deficiencies in current reporting practices, there is a paramount need to set out minimum standards of acceptability. More and clearer guidance has the potential to enable more concise and useful reporting according to clear principles and processes, thus helping preparers and users of reports – not increasing the burdens on them.

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

Comments

[7] For example, research conducted by the Ethical Trading Initiative, and War on Want's research on the garment industry, which refers to a number of high street retailers recognising the failure of their audits in capturing the reality of conditions in their supplier factories. See "Fashion Victims: The True Cost of Cheap Clothes at Primark, Asda and Tesco" Report available at http://www.waronwant.org/campaigns/supermarkets/fashion-victims/inform/13593-fashion-victims

Yes. This would provide a useful additional vehicle for investors to scrutinise the companies reporting and behaviour, particularly if it was directed specifically at sustainability information contained in the report and accounts. The approach of Aviva plc, putting their CSR report to an advisory vote, is worth noting here.

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

Comments
Non-regulatory initiatives such as awards and league tables can help drive up best practice. However these initiatives inherently fail to address deficiencies in the current framework. These deficiencies can only be addressed through verification and enforcement.

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
Directors pay or remuneration should be linked to how they manage and reduce the negative social and environmental impacts of their company's policies and operations, so as to encourage them to improve their social and environmental performance. The Association of British Insurers has published Responsible Investment Guidelines[8] which include recommendations on the link between executive pay and environmental, social and governance issues. Integration of environmental, social and corporate governance issues into

[8] Available at http://www.abi.org.uk/Media/Releases/2007/02/ABI_publishes_Responsible_Investment_Disclosure_Guidelines.aspx

remuneration should be required and encouraged, as the ABI Guidelines on Responsible Investment Disclosure recommend[9].

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
A comprehensive assessment of costs associated with the introduction of mandatory environmental and social reporting, has actually been conducted by The Commerce and Companies Agency of the Danish Government[10]. This report evaluates the costs of the new Danish legal requirement to report on environmental and social issues, finding that businesses' recurring costs depend on the type of reporting chosen, but vary between EUR 871 and 4,383 per business. It is important to also note, improvements to the reporting framework need not impose additional costs on business. In fact, they have been shown in some studies to improve financial efficiency. This is because much of the information companies disclose about their activities is for public relations purposes, including CSR and Sustainability reporting. An improved reporting framework may provide less incentive for companies to produce material that embellishes their social and environmental activities and impacts. This would enable companies to rationalise their processes and to reduce the overall cost of social and environmental reporting.

[9] Available at http://www.ivis.co.uk/Guidelines.aspx

[10] The Danish Commerce and Companies Agency (2010) Corporate Social Responsibility and Reporting in Denmark, Impact of the legal requirement for reporting on CSR in the Danish Financial Statements Act available at http://www.csrgov.dk/graphics/publikationer/CSR/CSR_and_Reporting_in_Denmark.pdf