BIS | Department for Business Innovation & Skills

Consultation response form: The Future of Narrative Reporting

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

Responses to the Consultation must be received by 19 October 2010

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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 believe that GSK is providing useful and relevant information in both of these areas, and, in our view, other major UK listed companies are likely to be providing similarly meaningful information. Subject to any specific legal requirements, such as the business review, companies and boards must generally be free to frame their narrative reports in the way they judge most appropriate. In the event that investors are not satisfied with the way items are covered by certain investee companies then they can always ask the management of those companies to provide further information, but given the vastly differing nature of companies and their businesses it is difficult to see how further regulation would improve disclosure in this area. We noted that in a recent Deloitte / ACCA survey on narrative reporting, 74 per cent of respondents wanted more discretion and less regulation on narrative reporting. We would agree with this sentiment. The survey also found that the general level of disclosure of the statutory business review requirements was very good.

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

Comments
The legal and regulatory reporting framework provides the general parameters within which companies are required to provide information on these issues, and companies also need to bear in mind commercial sensitivities when providing such information. The time and resources available for the preparation of the narrative reporting may also act as constraints, particularly for smaller companies. With regard to strategy, we believe companies generally seek to share their aims with investors and stakeholders, but this may inevitably be tempered with caution, as there is a potential danger that some people will regard an explanation of opportunities in the Annual Report as definitive commitment. In the area of risks, we believe that companies will disclose those risks which their internal reviews identify as the most important. We note that there is a risk of liability if material risks are omitted which later result in losses. While the "safe harbour" in the Companies Act 2006 is helpful, for those with US

listings, this can prove a very real concern, as witnessed by the growth in disclaimer wordings included in Annual Reports. We are aware that some companies may also be concerned that the disclosure of more detail about risks and uncertainties could give a misleading impression of their position.

Please see also our response to question 1.

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

Comments
Yes, we would expect such matters to have typically been reviewed at companies' board and/or relevant board committee meetings. The disclosures are likely to generally reflect those matters that have preoccupied the board throughout the year (subject to materiality, and commercial and political sensitivities). However, we do not think it would be helpful or appropriate to introduce some form of requirement that the board should specifically disclose its business.

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

Comments
Yes, based on our experience of engagement with our shareholders. We believe that this is also likely to be the same for other companies and their shareholders. In our view, shareholders will also be likely to access and use a wide range of other information and sources made available by companies, such as those cited by way of example in question 6 below.

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
Not applicable.

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
Not applicable.

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

Comments
Yes. There is scope to rationalise and simplify the requirements and to make them less prescriptive, so as to avoid boilerplate statements and to minimise the risk of the creation of a box ticking mentality. The aim of relevant legislation/regulation should be to facilitate the generation of more focussed and company-specific information for users of company report and accounts. As you will be aware, this is an area that the Financial Reporting Council has also been considering in its "Reducing Complexity in Corporate Reporting" project. Indeed, we think there could be potential to simplify Annual Reports by exploring the possibility of permitting companies to include only the business review. the corporate governance statements, and accounts in the Annual Report, and publishing other matters (such as static or slow-changing information) on a website. This should not involve any change of content, but investors might find such Annual Reports easier to access. There may also be scope to draw together the regulatory requirements of the various bodies setting narrative reporting requirements, to make it easier for companies to remain aware of and to help them ensure compliance with their various obligations.

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

Comments
Yes. There is an ongoing need - as well as an increasing demand from the investment community at large - for companies to ensure that their Annual Reports tell a cohesive "corporate story" throughout, rather than merely complying with a range of underlying reporting requirements. It is therefore vital for companies to ensure that this message is not obscured, and that shareholders can always see the "wood for the trees". It may also be timely for BIS to also review the various disclosure obligations in relation to the directors' report, and whether the requirements could be better structured and presented, since many of the requirements have grown piecemeal over many years to address various Government policy objectives

of the day.

Please see also our response to question 7.

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

No, we are strongly against the introduction of an Operating and Financial Review ("OFR").

There was extensive debate on this issue under the previous Government, resulting in the introduction of the business review. While it makes sense to assess how well the business review is working in practice, it would be premature to suggest that we need to revert to the OFR. In this regard, the new UK Corporate Governance Code recommends that companies include a description of their business model. When introducing this change, the FRC stated that *"there is currently a gap in reporting and that setting out in layman's terms the company's strategy for generating long term value would enhance the ability of investors and other users of reports to assess the disclosures required under the business review"*. Given that this change only applies to financial years commencing on or after 29 June 2010, we strongly believe that now is not the time to introduce yet further change.

In substance, the business review and the OFR are in any event broadly similar, the main difference being the reference to the reporting standards in relation to, and a formal auditors' review of, the OFR. As the auditors review the business review for consistency with the audited parts of the report and accounts, there is already a level of assurance in company reporting and there is certainly no shortage of best practice guidance.

Furthermore, reinstating the OFR requirements would be unlikely to lead to any significant improvement in narrative reporting or more importantly, the management of the underlying issues, and we see no significant benefit to companies or users of Annual Reports.. Most companies are, in any event, likely to already be going beyond the relevant statutory requirements. Please see our comment in response to question 7, which we believe is also relevant here.

Narrative reporting generally has received much attention in recent years from a wide range of organisations. In our view, there are no obvious gaps or weaknesses where further statutory or regulatory intervention is required or justified. Indeed, we believe that broadly there is a need for stability in the

reporting framework. That does not mean that there is not scope for some individual companies to improve their reporting, but pressure on them for improvement is best coming from their shareholders, to whom the annual report is addressed.

In our view, the current UK reporting framework is amongst the very best in the world, and UK companies are highly-regarded internationally for the quality of their reporting to shareholders. We believe that this is attributable in large part to the principles-based nature of the existing regulatory regime, and the flexibility that this creates. We believe, therefore, that a more prescriptive regime would actually weaken the quality of narrative reporting as companies are obliged to make box-ticking disclosures rather than attempt real communication. More change or prescription would inevitably also cost businesses more, in terms of internal resources and external fees, and erode the competitive advantage afforded to UK businesses by the current regime.

Finally in this regard, we note that, under the Prospectus Rules, an OFR must be included in a prospectus. However, we would suggest that consideration might also usefully be given by BIS to determine whether investors find it useful. In 2008, the Rights Issue Review Group's Report to the Chancellor of the Exchequer found that *"due to its length and complexity, most investors do not use the prospectus as a means of information prior to investment decisions".* The Group did not recommend the inclusion of an OFR in its proposed short-form prospectus, which suggests it considered that investors do not value the OFR highly.

<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
i) Not applicable. ii) Generally we feel that the requirements are sufficiently detailed to enable companies to give a comprehensive response on such matters. Please see also our comments set out earlier in the response form. iii) No, and, to our knowledge, there is also no noticeable demand on the part of the wider investor community for more detailed reporting in the business

review from the companies in which they invest.
Please see also our comments set out earlier in the response form.

<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
No, we believe that sufficient guidance already exists, However, it may be helpful for all the guidance to be made available/accessible at or via one location, eg via the Accounting Standards Board or the Financial Reporting Council's websites. The relevant guidance may inevitably need to be updated from time to time to ensure that it always remains in step with best practice.

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

Comments
We do not believe that it is appropriate for there to be an advisory vote on the business review within the Annual Report. Shareholders already have the opportunity to, and currently do, express their satisfaction with the wider governance and performance of a company via the annual votes on a company's Annual Report, directors' remuneration report and the re-appointment of auditors. In our view, this would also add further bureaucracy to the AGM process. We believe that support for the matters within the business review is implicit in the vote on the Annual Report. Adding a specific vote on the business review section could not only potentially lead to an increased level of boilerplate disclosure in this important area, but to a business review box ticking mentality, which would only ultimately serve to constrain the way in which companies communicate with shareholders on matters within the business review.

<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
The recently launched ICSA Hermes Transparency in Governance Awards is a welcome development and a good example of a non-regulatory solution, seeking to identify and reward high standards of disclosure, with the aim of encouraging improvements both in the disclosure process and in governance

performance itself.

However, while the principle of non-regulatory solutions is attractive, overall basic regulation should ensure an acceptable degree of comparable reporting for all shareholders. In our view, the Financial Reporting Review Panel ("FRRP") exerts a significant influence over corporate reporting, as company boards generally wish to avoid investigation by, or referral to, the FRRP.

In any event, we doubt whether an annual ranking of companies' Business Reviews would achieve the intended clarity of disclosure. Although a number of companies are motivated about positions in league tables, there are likely to be many for whom this would not act as an incentive. Finally, each company is individual and distinct and a comparison of different Business Reviews would not be comparing like with like. Any form of ranking is therefore likely to be somewhat arbitrary and artificial.

It is important to strike a balance between increasing burden on companies through prescriptive requirements on the one hand, and driving up quality on the other. At present we believe that there is a good balance, subject to the opportunities for the simplification/rationalisation of disclosure being fully explored. (Please see also our comments set out earlier in the response form).

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

Yes. The current disclosure requirements seek to provide for full and comprehensive disclosure, but the complexity and variety of companies' remuneration and reward schemes, can inevitably lead to complex disclosures in some instances. Therefore consideration might be given by BIS as to whether and how the current statutory disclosure requirements might be simplified.

However, we believe that, generally, the current level of disclosure in companies' directors' remuneration reports provides clear and helpful information to shareholders. Since the directors' remuneration report regulations were introduced, the quality of reporting has improved each year

as best practice has evolved.

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

We would be particularly concerned about any proposals requiring any further disclosure relating to the total remuneration paid to directors. Current 'best practice' disclosure allows investors to assess the total level of remuneration that would be paid for maximum performance and the level that would be paid if 'on-target' performance were achieved. Including a total remuneration 'number' would add a significant level of complication in determining how some elements of the package are to be valued which would need to be consistently applied for all companies. In our view, the disclosure of such a number would fuel media interest and encourage pay comparisons and potential 'ratcheting' rather than add any value to investors since these numbers can be misleading and not necessarily comparable across companies. In any event and as a broader point, we query whether the information provided about directors' remuneration, generally, under the current disclosure requirements is helping restrain, or has accelerated, growth in executive pay across UK plc.

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

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

Costs

Question 15:

If you can provide any information on costs associated either with the existing narrative reporting requirements eg preparing your business review or your views on potential costs and benefits in relation to any of the ideas in this consultation, please give details

Comments
A sizeable amount of time/time costs and audit costs are associated with the existing narrative reporting requirements. Any increased requirements would increase such costs without any significant benefit in terms of the quality of the business review. In our view, the quality of narrative reporting does not necessarily follow the quantity of either the prescribed underlying disclosure requirements or the resultant disclosures.