BIS | Department for Business Innovation & Skills

Consultation response form: The Future of Narrative Reporting

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

Responses to the Consultation by be received by 19 October 2010

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Please tick the box from the following list of options that best describes you:

	Quoted company
	Other company
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x	**Trade Union**
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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
At present, few companies are presenting useful and relevant information in their narrative reports. There are several problems with the information currently being presented. **Inclusion of 'bad news' is very rare** Business reviews suffer from the same problem that many CSR reports suffer from, in that it is very rare for them to include information that illustrates a poor performance (including ESG performance, not simply financial performance) or to highlight an area where the company is facing difficulties. Failure to cover areas where the company has problems as well as those where the company is doing well means that such reports are by definition failing to capture a proper discussion of risks and opportunities, which clearly requires the directors to look at areas where the company's strategy is vulnerable as well as areas of strength. There are too many examples of narrative reports simply ignoring areas where the company is facing difficulties. This approach clearly devalues narrative reports to the point of them being almost useless. **Forward-looking information is also rare** Few companies really try to look ahead in their narrative reports. While this is evidently harder to do than retrospective reporting, the requirements of section 417 of the Companies Act 2006 clearly require it, and at the time when the Act was introduced there was widespread support for the concept of forward-looking reporting. In particular, investors have made it clear that forward-looking reporting is of value to them in informing their assessment of and decisions relating to companies. While it was recognised when the Companies Act was introduced that best practice in this area would take time to develop, to date progress has been slow and patchy and, for too many companies, non-existent. **Lack of consistency and comparability** For all users of reports, including investors and company stakeholders, it is invaluable to be able to compare information both over time for the same company and between companies. However, the wide variations in how

companies report make comparability between them extremely difficult. Even comparing the same company over time is in many instances difficult to do. This greatly reduces the utility of narrative reports.

It could have been expected that after the Companies Act narrative reporting requirements were introduced, companies would experiment and develop new models of reporting to fulfil the requirements. Multiple good and best practice developments could have provided a justification for initially not requiring standardisation in narrative reports, and indeed could have informed guidance at a later date. However, with a few exceptions, this has not occurred, and the general standard of narrative reports is low.

Poor quality information

The points above all contribute to the poor quality of information that comprise the majority of narrative reports.

The TUC has a particular interest in employment-related information, which the Companies Act clearly stipulates should be included in narrative reports. The information relating to employment suffers from all the points outlined above, namely, information about negative employment-related issues is frequently excluded from reports, what is included is generally patchy and also varies considerably across different companies, there is little discussion of the strategic importance of employment relationships, nor of the risks and opportunities related to employment issues. These weaknesses substantially reduce the value of the information included.

Link to directors' duties

One way in which section 417 of the Companies Act was an improvement on the previous OFR proposals was the link made between the business review and the codified directors' duties set out in section 172 (indeed, this was an amendment that the TUC lobbied for). Section 417(2) states that the purpose of the Business Review is to help members of the company assess how directors have performed under their duty to promote the success of the company. This link to directors' duties has not had the desired effect of encouraging directors to set out how, in promoting the success of the company, they have had regard to the long-term impact of their decisions, the interests of their employees, supplier and customer relationships, community, environmental and reputational impacts (as per s172). This is a great pity, as approaching narrative reports in this way would be helpful in encouraging directors to reflect on how they have implemented their duties under s172, which would in turn help to improve performance in this area.

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

Comments
In our experience, constraints on companies providing good quality business reviews including forward-looking information and information on risks and opportunities include the following. • **Lack of demand from investors** While some investors clearly value the information provided in business reviews, too many fail to recognise the links between the information provided (or that should be provided) and shareholder interests. This is because too many investors do not recognise the link between many of the areas that should be included in business reviews, such as employees and employment relationships, and the ability of a company to generate long-term and sustainable returns. • **Lack of clarity on how and what to report** Many companies are clearly unsure about how to go about narrative reporting and would benefit from greater guidance. • **Lack of best practice examples** There is a danger that the generally poor standard of reporting in business reviews is somewhat self-reinforcing, as companies perceive the low standards of other companies' business reviews as legitimising poor quality reporting. • **Lack of understanding at director level of what is required and how this could benefit their company** The TUC believes that too few directors really understand how improved management, monitoring, measuring and reporting of the areas that are the subject both of s172 and s417 would contribute to the long-term success of their company. One of the aims of sections 172 and 417 taken together, as illustrated by Parliamentary debate at the time, was to encourage directors to pursue what could be the 'high-road' rather than the 'low-road' to company success. Looking just at employment as an example of one of the issues to which directors are required to have regard in s172 and to report on in s417, this means encouraging directors to pursue employment relationships based on mutual respect and trust, decent wages, investment in training and do on, as opposed to a strategy based on poverty wages, a hire and fire culture and little or no investment in training. The TUC has seen no evidence that the Companies Act 2006 has had the impact on behaviour and strategy that was one of the intentions behind the legal changes.

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

Comments
This difficult for the TUC to comment on. However, our view is that it is likely to reflect a lack of substantive discussion at board meetings on the risks and opportunities attached to areas covered in narrative reports, eg, employment issues and environmental impacts. This relates to the comments made under the last bullet in response to question 2 above.

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

Comments
In the TUC's view, the information included in narrative reports is generally, with some exceptions, of insufficient quality to help shareholders in their engagement with and decisions about companies.

<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
The TUC has at times raised with companies questions about employment-related information included in their reports. One thing that would help us to do this is if it were explicitly acknowledged that company reporting is aimed at a wider group of users than just shareholders. In addition, if companies were encouraged to consult their workforce about the information included about employees in their reports, this would firstly improve the quality of employment-related information included in reports and secondly make it easier for us to challenge information that is deficient or misleading. It would also make a big difference if shareholders challenged the quality of information in business reviews. Discussion with investors during the

consultation period showed widespread agreement among investors that the quality of information included in business reviews was generally poor. There are some investors that do systematically raise concerns about the quality of non-financial reporting with companies. For example, Aviva Investors has a policy of voting against the report and accounts of a company that does not disclose sufficient corporate responsibility information. Another example is PIRC, the Pensions Investment Research Council, which will advise clients to vote against the report and accounts of companies that do not disclose sufficient employment and environmental information in their reports. However, the TUC's strong impression is that these examples are the exception rather than the rule, and that many investors have not raised concerns with companies about the quality of the directors' narrative reports. If companies believe that their reports are aimed at shareholders and believe that their shareholders are content with their quality of reporting, this limits the impact of other users and commentators who raise concerns either about the quality of narrative reports in general or about particular areas of weakness.

Perhaps most important of all is issue of enforcement. There is a lack of clarity about what, if any, the existing enforcement regime is and how effectively it operates. It is not clear whether the Financial Reporting Review Panel has taken enforcement action on business reviews to date; however, what is clear is that the FRRP does not have the resources to undertake enforcement of business reviews adequately. This needs to be addressed.

<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, dialogue with the company, corporate social responsibility report)?

Comments

The TUC makes use of company websites, CSR reports and in some instances dialogue with particular companies.

Although we represent workers, universally recognised as a major stakeholder in companies, we do not have access to events such as analysts' briefings which would provide an opportunity for dialogue with companies over particular issues of mutual interest or concern.

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

Comments

The TUC believes improving the quality of reporting should be the aim of any modification of requirements, rather than reducing or simplifying the requirements per se. We do not see the existing requirements of s417 as either unclear or onerous, but they are expressed in broad terms. In our view, the greatest improvement to the quality of reporting would be brought about by giving directors more in-depth clarity on what is expected in narrative reports. This would have the effect of making it easier to produce narrative reports, and would maximise the benefits to companies and their stakeholders of undertaking narrative reporting.

See our answer to question 10 below for suggestions on how the quality of narrative reporting should be improved.

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

Comments
The TUC believes that it is important that information is clearly 'labelled' and that if other reports or sources of information are referred to, these are easily available on the company's website. The greatest improvement to the 'arrangement' of the information would be its presentation by companies in a consistent and comparable format to enable report readers to make comparisons both between companies and over time.

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
The TUC believes that there would be value in reinstating some elements of the OFR. **Statutory reporting standard** The current reporting standards appears to us to have had little impact on the quality of narrative reporting. This may in part be because of deficiencies in that standard, but it almost certainly reflects the fact that the reporting standard is entirely voluntary. The TUC's would support the introduction of a statutory reporting standard in order to improve the consistency and comparability of the information provided in reports. However, the TUC believes that the current ASB Reporting Statement: Operating and Financial Review would require significant improvement in order to be fit for purpose. **Enhanced audit** One of the major problems with narrative reports is their patchy, inconsistent nature and poor quality. Given these problems, the TUC believes that it is appropriate to consider how independent verification or audit could best be applied to narrative reports. There is an important question of whether audit requirements should apply to process (as was the case in the previous OFR proposals) or to contents, which would be consistent with the way in which financial information is audited, or some hybrid of the two. This is not the place to enter into detailed discussion of this point, but we flag it up as an area where more discussion and debate will be necessary before going forwards. In terms of implementation, there could be an argument for staging in relation to other reforms. For example, the TUC believes that it could make sense to bring a statutory reporting standard into force before bringing in a requirement for audit of narrative reports, to allow a degree of best practice development to emerge before narrative reports are subject to an audit process.

<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

The TUC believes that good quality reporting on the areas outlined above would be extremely useful to a wide range of report readers, including shareholders, employees, suppliers, customers and the general public. In practice, the utility of reports is limited by deficiencies in their quality.

As argued above, we believe that the quality of information in narrative reports would be substantially improved by improved guidance on the contents of reports in the form of a statutory reporting standard.

The TUC clearly has a particular interest in information on workers and employment relationships, and we commented above on the poor quality of reporting on these areas. While we believe that further clarification and guidance on the full range of issues to be covered in Business Reviews is necessary, we will restrict our comments on contents to our core area of expertise. At a minimum, the information on employees in Business Reviews should include the following:

- **Diversity and work life balance**
  At each level of the organisation a breakdown of staff numbers by gender, race, age and disability, supported by a description of policies on equal opportunities and work life balance and their implementation. In addition, the overall gender pay gap, gender pay gaps by job grade and gender differences in starting salaries should be reported.[1]

- **Training and development**
  The role of employee training and development in delivering the company's strategic objectives. In addition, information on training resources per employee (including average annual training

[1] The proposals on the gender pay gap come from an exercise led by the EHRC with the involvement of the TUC, CBI and other business groups and unions in 2009 to come up with recommendations on what large private sector employers should be reporting on. The full report is available at:
http://www.equalityhumanrights.com/advice-and-guidance/information-for-employers/gender-pay-reporting/

expenditure, training hours and type of training) and their distribution in terms of grade/pay and gender should be given. In addition, the overall spending on training as a percentage of total payroll expenditure should be included.

- **Employee representation and involvement**
  Whether trade unions are recognised for collective bargaining, and the extent to which employees and their representatives are (a) informed (b) consulted and (c) involved in decisions about changes to their own jobs and wider strategic issues.

- **Health and safety**
  Health and safety performance and the level of director involvement in safety issues, along with details of RIDDOR accident, disease and incident reports and all safety enforcement action and penalties.

- **Pay and pensions**
  At each grade, pay scales and the most recent pay increases.
  What type of pension scheme is offered; for defined benefit schemes, the accrual rate; and for defined contribution schemes the average employer contribution.

These points should be included in the statutory reporting standard proposed above.

There are strong strategic arguments for including the areas set out above in narrative reports. Below is a case study of why improved reporting on training and skills would bring both company and wider economic benefits.

Case study: why improve reporting on skills?

In autumn 2009 the UK Commission for Employment and Skills (UKCES) reported on a comprehensive review of 'employer collective measures' which had the potential to be used as levers to increase employer investment in skills on a collective basis. The impetus for this inquiry had originally come from a recommendation by Lord Leitch in his review of skills. The UKCES recommended four specific action points, including undertaking 'further work to explore different approaches to developing the reporting of human capital ranging from regulation (the accountancy standards) to encouraging changes in behaviour.'

According to the UKCES there would be a range of benefits from such a policy approach. For example, it would provide a focus on training at management level and incentivise senior managers to work together to

[2] Schuller, T. and Watson, D. Learning through Life: Inquiry into the Future for Lifelong Learning, NIACE, 2009

'develop more effective training practices and to better present the value of firms' human resources.' At the same time there would be much more pressure on firms to give due regard to this on the grounds that 'investors and shareholders would have a clear guide to the levels of training expenditure within a firm which may guide investment decisions in the stock market.' The UKCES also argue that more detailed knowledge of employers' approaches to training and HCD would also allow government to consider using more sophisticated incentives (e.g. some form of tax break) to encourage greater levels of investment in training by employers. The TUC agrees with this analysis and recommends that the government should work with the UKCES to consider how best to take forward this agenda.

However, there is also a case to be made for requiring employers to report their investment in training. This should be part of a new requirement for receipt of corporation tax relief on training expenditure. According to a major inquiry into lifelong learning commissioned by NIACE[2] , currently some £3.7 billion is given to employers in the form of tax relief (corporation tax and PAYE) on employee training. Yet there appears to be almost no regulation on what can be claimed. For example, employers can claim for courses which do not lead to any accreditation. They can also claim for induction training for new employees, including wage costs. Attempts to collect data have been met with the response that data on this relief is simply not collected, which is extraordinary considering the immense scrutiny and data requirements of other government investment in workplace training. Moreover, there is very little tax relief of this kind available to individuals (including the self employed), which seems strange if the rationale for any relief is that the state should encourage more training among working people. One of the recommendations of the Inquiry into Lifelong Learning is that there needs to be tighter conditions and greater transparency in accounting for this form of tax relief in company accounts and the TUC strongly support this approach.

The TUC also believes that the scope of the narrative reporting requirements should be reviewed. The extensive debate over the impact of private equity buyouts on their portfolio companies led to the review by Sir David Walker of transparency in the sector and his recommendations on disclosure by both private equity funds and their portfolio companies. An argument that came up in his report and has been repeated many times since, is that private companies owned by private equity funds are now required to report significantly more information that even the very largest private companies that are not owned by private equity funds. The TUC has always argued that all large and medium sized companies should be required to produce a full business review, including reporting on future developments, environmental matters, employees, social and community issues and supplier relationships as set out under s417(5), and we continue to support this view. It is particularly inappropriate that large private companies, which by nature of their very size have major economic and social impacts, are excluded from

the requirements of s417(5). The TUC urges the Government to take this opportunity to create a more level playing field in company reporting and extend the requirement under s417(5) to large and medium sized private companies.

The TUC also believes that s417(7) which permits medium sized quoted companies not to include key performance indicators on environmental and employee matters should be removed. Employment and environmental impacts are of direct relevance to investors and other stakeholders regardless of company size, and there is enough flexibility within the requirements without this exemption.

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

The TUC believes that more guidance is essential in driving up the quality of narrative reporting. As set out above, we believe that a statutory reporting standard is the best way to do this. Please see our answers to questions 9 and 10 above.

Best practice examples may be helpful for driving up standards among companies that are committed to the principle of good quality narrative reporting but unsure how to go about it, but they will do little or nothing to drive up standards among the laggards of narrative reporting, which will require clear minimum standards. Best practice guidance then is not a substitute for minimum standards, but may bring additional benefit.

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

Comments

The TUC strongly supports the proposal to hold a shareholder's vote on the Business Review. We believe this will do a great deal to focus the minds of both investors and directors on the quality and contents of their business reviews. It will also provide investors with a way of signalling concern about an issue included in the Business Review without requiring a vote against the company's report and accounts as a whole, which many investors are very reluctant to do.

The financial crisis has cast a spotlight on current weaknesses in investor engagement with companies. The TUC believes that putting the Business Review to the vote would be a useful tool to improve engagement between investors and companies. The Stewardship Code published in September by the Financial Reporting Council sets out principles for investor stewardship of the companies whose shares they own. The TUC runs a network for trade union member-nominated pension fund trustees, and we are aware of how difficult it can be at times for trustees to engage effectively with asset managers over issues relating to corporate behaviour. We believe that a vote on the Business Review would provide a focus for boosting discussion of engagement and its impacts among asset owners such as pension funds, as well as asset managers.

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

Comments

The TUC believes that both better guidance and greater publicity of excellence in narrative reports could be helpful. However, we do not believe that they are a substitute for statutory minimum standards, and without these the majority of companies that produce low-quality or misleading Business Reviews will continue to do so.

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

One of the areas of greatest failure of corporate governance is the area of directors' remuneration. From the Greenbury Committee through to the Directors' Remuneration Report Regulations 2002, the approach that has been taken by regulators and market participants to directors' pay is that providing information to shareholders will enable the latter to monitor directors' pay and act to ensure that it is appropriate. The TUC believes that this approach has simply failed.

Remuneration reports currently include little information on the process of setting executive pay or the criteria that have informed their decisions. Under Combined Code supporting principle B.1.1, remuneration committees 'should be sensitive to pay and employment conditions elsewhere in the group, especially when setting annual salary increases'. This principle is routinely ignored by companies. There is no evidence that any remuneration committees have considered the pay of other staff in the company when setting directors' pay. This principle is rarely mentioned in remuneration reports and when it is it is usually a bland, one-line assertion with no supporting evidence. This is still the case, despite clarification since the Companies Act 2006, that companies should explain how they have complied with this principle.

For shareholders and others to judge the extent to which companies are complying with Combined Code principle B.1.1, it is essential that companies are required to disclose clear information on the distribution of pay across the company as a whole and the ratio between top and bottom.

Remuneration reports should be required to include information on:
(1) the ratio of highest director total pay to lowest employee pay in the company;
(2) the distribution of pay throughout the company as a whole by grade;
(3) each director's increase in basic salary for each of the last three years;
(4) the average pay increase for staff elsewhere in the company for each of the last three years.
viii) Where the average rise in basic pay for directors is significantly higher (say more than 1%) than the average rise for employees, an explanation for this differential from the remuneration committee should be included in their report.

Costs

<u>Question 15:</u>
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
The TUC believes that in assessing costs and benefits, it is important the Government takes into account the benefits to company management and performance that good quality narrative reporting should bring. Narrative reporting should not be viewed just as a monetary ‘cost’ without proper consideration of the potential benefits.

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