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Dear Sirs

ICSA response to the BIS consultation on "The future of narrative reporting"

Introduction

ICSA welcomes the opportunity to respond to this important consultation, drawing on the experience and insights gained from devising the ICSA Hermes "Transparency in Governance" awards – an initiative introduced to improve standards of narrative disclosure in annual reports.

ICSA feels that standards of narrative reporting have improved over recent years and concurs with the sentiments expressed in the consultation document that "UK companies ... rank among the best in the world in their standards of corporate governance and reporting[1]". It would be difficult, however, to sustain the claim that there has been a general step change improvement in disclosure performance. As we point out on page 9 of our report following last year's Awards[2], standards of disclosure are inconsistent, and the quality of companies' narrative reporting diminishes in quality as one moves out of the FTSE100, and into and beyond the FTSE250. Similar challenges are encountered for non-listed companies, where the issue of disclosure is also relevant.

There are two basic causes for this inconsistent performance:

- There has been no vision, articulated from the centre, on the purpose and benefits of high-quality narrative disclosure. The abolition of the mandatory OFR in 2005 caused uncertainty and confusion at the time and, since then, peer pressure, market dynamics and, occasionally, regulatory oversight from the Financial Reporting Review Panel (FRRP), have not been enough to trigger and sustain improved levels of performance.

[1] Forward by Edward Davey, Minister for Employment Relations, Consumer and Postal Affairs to the BIS consultation on the future of narrative report.
[2] 'Delivering transparency, changing behaviour – Improving governance disclosure in annual reports'

- Companies have not sufficiently understood the benefits to be gained from viewing their disclosure obligations as a communication opportunity. This stems often from a lack of leadership and vision within the company itself.

The consultation exercise provides an excellent opportunity to address these shortcomings. In this response we would like to highlight some key issues which we feel are of particular importance, and make specific responses to some of the consultation questions.

The importance of high standards of disclosure

ICSA considers that high quality narrative reporting is a fundamental building block of the governance pyramid.

S Gillen, ICSA

A company's ability to evidence, through disclosure, the strength and quality of its governance arrangements is central to its success in instilling confidence in its shareholders, and other stakeholders, that it can execute its strategy successfully. This generates trust, improves the company's reputation, and leads to increased levels of stakeholder support. High standards of disclosure therefore confer business benefit, allowing a company to position itself positively with its shareholders and other stakeholders.

At the same time, as the consultation paper makes clear, corporate accountability is an important public policy issue. The Business Secretary has made clear that companies should be able to account for what they do, and how they do it, as part of the wider role they play in society. Not only does this concern the relationship between companies and their owners, allowing shareholders to engage and make well-informed decisions, it also relates to the fact that "... transparency in investment and governance decisions ... has come to be a wider issue of public confidence."[3] Narrative reporting provides one of the key mechanisms for delivering this accountability agenda, and forms part of the wider disclosure strategy companies should have in place.

High standards of disclosure therefore provide a platform of mutual opportunity for the corporate and political/regulatory communities.

The Annual Report and Accounts

[3] Business Secretary's speech to the FRC Stewardship Code launch, 19 October 2010

The Annual Report and Accounts should therefore be acknowledged, and promoted, as *the* flagship publication of a company, providing a reliable, audited annual reference document containing the key information relating to that company. Companies should be encouraged to place greater importance on the role the report plays in delivering strong narrative reporting performance.

That said, we should avoid expecting too much of certain aspects of an annual report. There should be less preoccupation with whether people *read* a report, and more emphasis on its usefulness and ease of use, balancing completeness and accessibility. There should be less emphasis on the annual report as the main communications initiative of a company, and greater acknowledgement that the report is a snapshot of the company at a fixed point in time and forms only part of a company's wider suite of communications. There should be less focus on whether the delivery mechanism is through hard or soft copy, and more understanding that it is the content which matters, and that creating and communicating that content represents an important alignment exercise within a company. These considerations apply irrespective of issues of company size, industry, shareholder/stakeholder base, availability of resources (expertise and financial), and access to advice.

Theme 1 – Audience and content

We need greater clarity on the audiences for an annual report. Although the business review is written for the benefit of the members, the espousal of the principle of enlightened shareholder value enshrined in section 172 of the Companies Act, and the primary purpose of the business review as articulated in section 417 of the Act, makes it important for report preparers to reflect the contribution of stakeholders other than shareholders in the process of value creation. The acknowledgement of the role of these other stakeholders then makes the annual report narrative relevant to a wider group of users.

If the narrative is subsequently viewed as a disclosure obligation only to shareholders, the wider communication opportunity to these business-critical stakeholders is lost. Taking this analysis one step further, if a report does not make sufficient acknowledgement of the role of stakeholders in the value creation process, it is arguably not telling the whole story, and the report could justifiably be considered incomplete.

Some of the 'audience and content' tension can be managed by guiding companies to focus on business-critical reporting. A large number of companies need to demonstrate greater recognition of the importance of various stakeholders in delivering the business model, while a smaller number of companies need to be encouraged to pare back on excessive and irrelevant levels of non-financial disclosure.

The 'audience and content' tension also requires special effort to avoid the practice of several departments writing different parts of the report and approaching it from different perspectives. This is where higher levels of leadership and ownership from the board are critical in setting expectations in terms of communicating one coherent story.

Stakeholders, particularly shareholders, need to provide constructive feedback to companies as to the content they wish to see. Feedback is a non-regulatory tool which can improve the quality of narrative reporting – without it there is no incentive, especially for small companies, to improve and move away from boilerplate statements. Feedback should be achieved via ongoing dialogue with the company and not, for example in the case of shareholders, solely negative voting at an AGM.

Theme 2 – Incentives/awards v sticks/rankings/regulation

Companies need to be incentivised to deliver good disclosure performance, which means helping them understand the business advantage that good governance and transparent reporting can bring.

Awards informed by independent assessment can play a significant role in helping consolidate this process, and this is what the ICSA Hermes Awards set out to achieve. The judging panel is composed of the main professional interests working at board level, and committed to improving board process – investors, regulators, accountants, lawyers, auditors, risk managers and company secretaries. We would be happy to discuss further with you our experiences of how this process has worked, and whether there is any scope for developing the concept in a way that the government would find useful.

If expert panels were to become involved in formal assessment, this could lead to a significant amount of second guessing. While the FRRP oversight model could be developed, this solution would need to be thought through carefully. Nevertheless, such a model might be one means of addressing the issue of those annual reports which are clearly inadequate in terms of their standards of narrative reporting disclosure, although such an approach would need greater clarity from the centre on what standards are expected.

Greater regulation, for its part, will inevitably lead to prescription, and boiler plate reporting, when we are looking to encourage the opposite outcome – an emphasis on diversity and flexibility in reporting arrangements to allow each company to communicate its unique characteristics.

For the same reason, ICSA does not consider that rankings and league tables will work as a means of bringing about improvements in standards of narrative disclosure. Companies are individual and distinct from each other – no two business models are the same – and it is impossible to begin an exercise of comparing like with like. Any ranking effort would be arbitrary and artificial, and may not be sufficiently robust. It might also lead to shareholders and stakeholders relying unduly, and unjustifiably, on the rankings. The idea may seem attractive, but it would be impractical. If management is opaque in its reporting, this is generally a reasonable indicator that governance is not a priority, and shareholders and stakeholders should be encouraged to come to this decision themselves.

<u>Theme 3 – Best practice guides/example KPIs</u>

We note that there is often a call for further guidance, particularly from smaller companies, for examples of common types of risk scenarios, KPIs, clarity on the nature, purpose and role of CSR reporting, identification of areas of reporting which are neglected or missing and the provision of solutions. This is often due to a lack of resources (time and money) or access to consultants/advisers that larger companies may have. These companies require *illustrative* but not prescriptive guidance to be found in one place, in order to help them identify what is relevant to *their* company.

The counter argument is that there is sufficient existing guidance in place, often provided by professional bodies and commercial concerns, such as corporate reporting agencies. Some of these organisations already provide workshops or seminars designed specifically for individuals or company teams (company secretarial, accounts, PR/IR) involved in report writing.

Further hard guidance by standard setters may not be desirable, but the articulation of a vision for narrative reporting, and the creation of guiding principles, may help clarify some of the issues where there seems to be need for greater understanding of what is required. This should be supplemented by a commitment from the board to the importance of delivering high standards of narrative reporting, with corresponding support for report preparers to have access to training and education to help them understand how a company can benefit from preparing a high-quality narrative.

Theme 4 – Future concepts for narrative reporting

Future concepts would need to be demand-driven and market-oriented solutions, rather than something introduced by regulators and standard setters. Companies and shareholders and other stakeholders would need to work together to create a different future from the one which is currently evolving. Factors to be considered when designing a new system include user needs; leveraging the technology; a focus on quality; timeliness; relevance; different sectors, and sizes of company**;** the need to codify after piloting; what regulatory regime will support a demand-driven outcome; and education in the new format. There will be others. Revising the narrative reporting system would be a sizeable task and could not be introduced quickly. It would also be necessary to consider how reporting regimes in other jurisdictions were evolving, and whether transformational change in the UK – whether rapid or slow – would be compatible.

Specific issues

Qu. 1&2 Commentary on forward-looking strategy has improved but it still tends to be statements of generalities. While it is sometimes difficult to comment in detail without disclosing matters of commercial sensitivity, this is not always the case – for example it is normally possible to comment on the first few months, or quarter, of trading following the close of the year end.

Other disclosures have been legally sanitized, resulting in broad statements rather than specifics. Likewise reporting on principal risks and opportunities has improved, but some of our members claim it is hard to disclose more detail without giving a misleading impression of the company's position. Guidance and education on identifying, prioritising and reporting key risks has been one of the areas highlighted by our members (See Theme 3). It is also noted that the requirements of the new UK Corporate Governance Code will impact on companies' reporting of both strategy and risk[4].

It is ICSA's experience from the Awards scheme that it *is* possible for companies to achieve high standards of performance in these areas, and that it may be a case of encouraging other companies to learn from the good reporters so that they can improve their own performance.

Qu.7 We consider that the Directors' Report, which has grown through legacy additions and issues from previous companies' acts, could be simplified. Some of the content could be included as notes to the accounts; other areas should be reported on if applicable to that company – R&D and the company's location, for example, need not necessarily be in the Directors' Report. Static or slow-changing information could either be located elsewhere, for example in a company's articles, or included on the website (with an obligation to maintain), provided cross references are included along with details of where documents can be obtained. This would arguably make the annual report more focused on issues which are of value, rather than technical in nature, and move report writers towards the desired direction of drafting to "tell it how it is", rather than rely on boiler plate.

However, this approach may be considered to run counter to the argument that there should be one complete reference document available, and highlights an area where shareholder/stakeholder feedback would be useful.

Qu. 8 Some of our members feel that the current structure of the annual report generally works well, as most companies follow a pattern which is easy for readers to use.

[4] UK Corporate Governance Code June 2010 Section C Accountability

However, others feel the format is restrictive, and causes repetition, and they would prefer the framework to be freed up, whilst preserving the core content, thereby allowing companies discretion/freedom as to how to present the information more effectively in order to 'communicate and inform', not just disclose. This is an area where ICSA considers there would be merit in investigating a more free-style approach.

Qu. 9 The Business Review requirements are very similar to the OFR and so the re-introduction of the latter would not necessarily place too much of an additional burden on quoted companies. It would depend, however, on what level of mandating or obligation were introduced in terms of all or specific provisions, and it would also depend on how companies were encouraged, or felt able, to deliver those obligations. Many companies have demonstrated, for example, that they experience difficulty in delivering business-critical disclosure. Some of the areas where the consultation paper is calling for more disclosure are in areas where understanding the concept of materiality has always proven a problem. This issue needs to be addressed before a formal OFR mechanism is introduced.

Qu.10 As detailed above, the Business Review provisions require information essential to assessing how the directors of the company have fulfilled their obligations to promote the long term success of the company (s172 and s417 of the Companies Act 2006). Reporting on the role and contribution of stakeholders in creating value in the business model remains an area which is poorly understood, and implemented. Asking companies to disclose more meaningfully on issues relating to their reputation among stakeholders, and the issue of reputational risk, would help develop thinking and practice in this area.

Some companies provide more expansive reports on social and environmental issues published via alternative media forms, and feel that duplication of effort will result, if a requirement to disclose further information in the Business Review is introduced. However, the annual report should take precedence in terms of the location of relevant content, and shareholders, as well as other stakeholders, should be able to go to that document first to view material non-financial disclosure.

Qu.12 Although ICSA appreciates the argument that an advisory vote on the Business Review would ensure it received due attention, and would enable shareholders to challenge on issues where they were not content, there is a stronger argument for encouraging shareholders to engage on an ongoing basis with the company. Negative voting is not the most productive form of open dialogue, and rarely provides a mechanism for constructive feedback.

Given that there are also suggestions from the EU that there should an advisory vote on the Corporate Governance Statement in financial services companies – a practice that might extend to all listed companies – our general feeling is that the increase of multiple advisory votes on sections of the annual report and accounts is not helpful. A board of directors should be held to account for all aspects of the company's activities, and not specific sections.

Qu. 13 As explained above, ICSA considers that the non-regulatory solution which best increases the probability of imposing the quality of disclosure is by acknowledging and rewarding excellence through an awards process. We would be happy to discuss further with you, along with Hermes colleagues, what more we could do in this area.

Qu. 14 The current disclosure requirements for remuneration are specific, and disclosure

is generally good. Disclosure on performance criteria for payments to directors, and how this relates to the company's strategy, demonstrable links between pay and performance, and the process by which remuneration is decided, are all areas which can be patchy. However, we generally feel that companies should be free to adopt remuneration practices relevant to their circumstances and it should be a matter between the company and its shareholders, principally, as to what information should be disclosed. Rather than prescriptive legal requirements, guidance and education as to the types of information that shareholders might find beneficial would be more helpful to companies and shareholders.

Qu.S.30 We do not support the suggestion that the narrative report should be limited to a summary of strategic issues with more detailed supporting information presented separately for those requiring it. High-quality disclosure requires supporting information, not least on issues such as risk, and the overall narrative needs to be a rounded picture representing the various aspects of the business model, of which strategy is only a part.

Conclusion

Narrative reporting has improved but the bar needs to be raised across all sizes and types of company. Legacy issues of previous companies' acts, confusion as to the audience and content, and lack of skill in determining issues of materiality are some of the causes which have, collectively, led to poor-quality and sometimes bland and legalistic disclosures, rather than useful communication and information.

There cannot be a prescriptive 'one size fits all' solution to the challenge of improving standards of narrative reporting. What is most needed is a clearly-articulated vision from the centre on what narrative reporting should seek to achieve, the benefits to all parties in achieving higher standards, and more leadership from within companies to commit to higher standards. All players should be encouraged to buy into the concept that high standards of disclosure are an aspect of good governance and, through an improved company reputation, can become a business enabler.

Finally, awards have an important role to play in supporting high standards of narrative disclosure and can serve to strengthen the incentives which need to be introduced to deliver sustained improvements in performance.

Yours faithfully

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ICSA