The future of narrative reporting

Submission from The Association of Investment Companies

The Association of Investment Companies (AIC) welcomes the opportunity to respond to the Department of Business Innovation and Skills's consultation on the future of narrative reporting.

The AIC is the trade association representing the closed-ended investment company industry. Its membership comprises some 348 investment companies with £76 billion of assets under management. Investment companies have an interest in the narrative reporting framework as both issuers of and investors in shares. The large majority of our members are traded on EU regulated markets and are subject to the disclosure obligations of the Transparency Directive. Most of our members are also domiciled in the UK and must comply with the disclosure requirements of the Companies Act 2006 (2006 Act). Investment companies invest in a diversified portfolio of assets, including shares of UK companies, with a view to providing their shareholders with a financial return. As investors, investment companies are interested in the quality of information presented in annual reports.

General comments

The AIC is supportive of BIS's review of the narrative reporting requirements. We have long been concerned about the length and complexity of information which is produced in the front sections of the annual report. It is not unusual for a set of annual accounts to run to a hundred or more pages. To assume that it is appropriate to disclose to shareholders every conceivable piece of information about the company is misguided. The key objective of the annual report is to inform shareholders about the performance and development of the company. Lengthy documents make it difficult for shareholders to extract the key points of interest which are lost amongst more 'boilerplate' routine disclosures which are included less to inform shareholders but rather 'just in case' their omission creates some kind of liability.

The AIC supports BIS's position that this review should not increase the regulatory burden placed on companies. The consultation provides an excellent opportunity to simplify the disclosure regime and to reduce or removed reporting obligations. For this reason, the AIC **recommends** that companies are not required to prepare a 'summary of the strategic issues' in the annual report. This will increase the volume of information which must be produced and provide shareholders with no more additional information than can already be found in the chairman's statement.

One issue which adds to the complexity of narrative reporting is the degree of overlap between different sources of regulation and guidance, particular for listed companies such as investment companies. For example, both the Disclosure and Transparency Rules (DTR) and the 2006 Act require the annual report to contain a 'fair review' of the business and a description of the principal risks and uncertainties. Both also require forward-looking

statements, although the level of detail required differs. Whereas the DTR calls for *"an indication of ….the issuer's likely future development"* the 2006 Act requires companies to disclose *"the main trends and factors likely to affect the future development, performance and position"* of the business. There is also overlap between the corporate governance obligations in DTR 7 and the UK Corporate Governance Code (UK Code), resulting in the Financial Reporting Council introducing a six-page appendix to the UK Code to compare the two approaches. Another example is risk disclosures which are required under the DTR, Listing Rules, 2006 Act, accounting standards and the UK Code. This encourages a scattergun approach to disclosing risks which might be better presented within one risk statement.

The AIC **recommends** that BIS considers how the interaction of the different regulations covering narrative reporting can be improved. Regulatory overlaps place unnecessary burdens on companies which are required to devote additional resources to understanding and comparing the different rules, and considering how best to amalgamate the disclosures into a user-friendly document for shareholders. The situation partly arises because of the development of both European and UK regulation, but the AIC believes that there is scope to simplify the regime. For example, where the rules overlap precisely, cross-referencing could be used to remove repetition. Where the intention behind the rules is similar but the wording differs, consideration should be given to aligning the requirements.

In relation to reporting on corporate governance, the priority of the UK Government should be continued support for the 'comply or explain' regime. This provides companies with flexibility to present explanations to shareholders where they decide to move away from normal best practice and adopt alternative arrangements which are more suited to their particular circumstances. This approach provides shareholders with useful information about the company and allows them to form a view of the appropriateness of decisions taken by the board. This in turn encourages shareholders to engage with the company where they do not support the position taken by the board. The 'comply or explain' approach therefore goes some way to achieving one of the objectives of the current review, which is to empower shareholders.

The principles-based approach taken by the UK Code also encourages companies to provide more informative disclosures to shareholders to reflect their specific circumstances. Where rules are written in a detailed and prescriptive way, the resulting disclosures are more likely to be narrow and provide little useful information to encourage shareholder engagement. Policymakers should bear this in mind when drafting regulation.

The AIC is concerned about the direction of discussions in Europe on the corporate governance disclosure framework. In particular, it appears that the distinction between corporate governance and regulation is being inappropriately blurred. For example, in the Commission's green paper on corporate governance (which can be found at http://ec.europa.eu/internal_market/company/docs/modern/com2010_284_en.

pdf), it is consulting on whether financial institutions and banks should be required to establish a risk committee and on the role of the chief risk officer. Our view is that risk oversight in these sectors is too important to be dealt with through corporate governance. Corporate governance should be about boards reporting to their shareholders how they have carried out their responsibilities in relation to the company. It should not be used as an alternative to introducing regulation and to reporting on matters which should be notified to the regulator. This approach does nothing to improve the quality of narrative reporting. The AIC's response to the green paper can be found at www.theaic.co.uk/Documents/Technical/AICconsultationresponsegreenpaper corpgovAug2010.pdf.

As part of BIS's review of the future of narrative reporting, the AIC **recommends** that it considers the statutory liability regime relating to disclosures made in, and omissions from, the annual accounts and in particular the recent changes to section 90A of the Financial Services and Markets Act 2000. It may be that adjustments could be made to reduce the problem of excessive disclosures made simply to offset potential liability rather than communicate key information to shareholders.

BIS should also note that, following consultation, the International Accounting Standards Board is shortly expected to publish the final text of a non-mandatory framework on 'Management Commentary'. In considering changes to the UK regime on narrative reporting, BIS may wish to take these developments into account.

Consultation questions

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

Companies generally do provide useful and relevant information on their forward-looking strategy. For an investment company, its future strategy will be set out in its investment policy which it is required to publish under the Listing Rules. This must set out the company's policies on asset allocation, risk diversification and borrowing, and explains to shareholders how the company's assets will be invested.

There may be scope for improving the way in which risks are disclosed in the annual report. It is not unusual for risk information to be located in various places throughout the document, for example in the directors' report/business review, corporate governance statement and the notes to the accounts, and, for investment companies, in their investment policy. As discussed above, this may reflect the fact that rules on risk disclosures come from a range of regulatory sources. There may be scope for improving how this information is organised and presented to shareholders in a more coherent manner. For example, it may be appropriate to use more cross-referencing to bring the information together or to provide one risk statement in the annual report which collates all the relevant risk disclosures.

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

Preparing disclosures on strategy and principal risks and uncertainties should not be overly burdensome for companies. These are issues which a board will consider in depth on an ongoing basis and relevant documentation will be regularly prepared as part of the board papers. The work required to convert this information into a statement suitable for inclusion in the annual report should be easily manageable, although the board, and the chairman in particular, may want to spend some time considering how the key messages are communicated to shareholders.

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

See answer to question 2.

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

As discussed above, shareholders are more likely to engage with boards which avoid 'boiler-plating' their reports, and which provide information to their shareholders which is specific and relevant.

Narrative reporting in the annual report is only one of many tools which shareholders use to inform their business decisions. Financial information is also important and access to up-to-date performance figures is vital for shareholders to monitor their investments.

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?

The vast majority of investment companies outsource their day-to-day management and administration to a management company. As part of this arrangement, the investment company board will agree a policy with the manager regarding engagement with investee companies. Principle 16 of the AIC Code of Corporate Governance, which is endorsed by the Financial Reporting Council as an alternative means for investment companies to meet their obligations in relation to the UK Corporate Governance Code, recommends that investment company boards agree a policy with their manager regarding voting and corporate governance issues in respect of holdings in the company's portfolio.

It may be appropriate for no engagement to take place at all, for example in the case of tracker funds. At the other end of the spectrum, a venture catpial trust may place a representative on the board of the investee company to have much greater involvement in its strategic development. Therefore, the extent to which an investment company (through its manager) may challenge

the information provided by an investee company differs, depending on the approach agreed with the manager.

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)?

N/A

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

As discussed above, the AIC believes there is scope to reduce the extent to which the requirements on narrative reporting overlap.

Reporting obligations could also be improved if companies are no longer required to produce interim management statements (IMS). These reports are published around the first and third quarter ends and contain primarily narrative disclosures. IMSs may be outside the scope of the current review but impose a significant burden on companies without clear evidence that shareholders place any significant value on them. In light of its current review of the Transparency Directive, the AIC has recommended the abolition of interim management statements to the European Commission.

If the Commission concludes that it is not appropriate to remove the rules on interim management statements, then the AIC has provided alterative recommendations to simplify the reporting requirements. For example, it has recommended to the Commission that an IMS should cover a strict quarter period and have a set publication deadline. The AIC's response to the Commission's review of the Transparency Directive can be found at www.theaic.co.uk/Documents/Technical/AICconsultationresponseEUtransparencyAugust2010.pdf.

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

As discussed above, information on risks could be presented in a more organised way.

The review should also focus on reducing the volume of information which companies are required to disclose. Fewer, but more relevant, disclosures would improve the quality of narrative reporting and provide shareholders with more scope to engage with boards.

9. Looking at an Operating & Financial Review and the existing business review (see Annex D), do you see value in reinstating elements of an OFR and if so what would they be? In particular, would a statutory reporting standard help to improve the quality of reporting?

The AIC **recommends** that the current rules on business reviews should remain unchanged. They have now been in place for three years and most companies will have completed the process of understanding and implementing the rules. There is no justification for changing the framework unless specific regulatory failures have been identified, which the AIC does not believe is the case.

Given the high degree of overlap between the OFR and the business review requirements, there is no value in reinstating the OFR. If it is decided to re-introduce one or both of the two main elements of the OFR which are not currently included in the business review, namely an enhanced audit requirement and the statutory recognition of a reporting statement, then this should be done by amending the business review rules.

10. The business review provisions require quoted companies to report, to the extent necessary, on:

- **main trends and factors likely to affect the future development, performance and position of the company's business**
- **information on environmental matters**
- **information on employees**
- **information on social and community matters**
- **persons with whom the company has essential contractual and other relationships**

  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?

Disclosures on environmental, employee, social and community matters are not relevant for the majority of investment companies because their unique structure means that they have no employees, no property and no physical operations. The current provisions require investment company boards to justify to their shareholders why these disclosures are not given. This is an example where the narrative reporting framework results in the production of unnecessary and irrelevant disclosures which distract from the main purpose of informing shareholders about the performance of the company.

More flexible rules which recognise that companies have different approaches would improve the quality of reporting. For example, the AIC **recommends** that this provision is amended to only require disclosure of environmental, employee, social and community matters "where appropriate". If these disclosures are not relevant to a company's business model, then the board can spend more time focussing on core issues. Where companies do have relevant issues to report but fail to do so adequately, shareholders and regulators have mechanisms with which to raise this with the company concerned. We **recommend** that guidelines could be set to indicate where disclosures should be made. For example, no disclosure on employee matters might be required for companies with under 250 employees. No environmental disclosures might be required for companies which do not emit

over a certain amount of carbon dioxide (see below) or have physical operations limited to office space under a certain size e.g. 10,000m^2 or type.

As discussed above, the AIC does **not recommend** that additional items are added to the business review provisions. The objective of this exercise is to improve the quality of narrative reporting. This will not be achieved by increasing the volume of items which must be reported on. If there is scope for information to be removed, the AIC would support such deletions.

The AIC understands that BIS is committed to introducing regulations on greenhouse gas reporting. The AIC **recommends** that the new regime adopts a 'comply or explain' approach which recognises that these disclosures may not be relevant for all types of companies. For example, investment companies do not generate greenhouse gas or other emissions of any significance. The AIC **recommends** that the regime incorporates a de-minimis level below which companies are not required to report. This could be based on the new CRC Energy Efficiency Scheme which places a number of statutory obligations on organisations which consume over 6,000 MWh of electricity per year, roughly equivalent to a bill of £500,000. Where companies are not subject to this scheme, they should not be required to report their greenhouse gas emissions.

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

Given that the business review provisions have been in force for three years and that companies have now fully implemented the requirements, the AIC does not believe that further guidance is necessary at this stage.

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

The AIC **recommends** that there is no shareholder's advisory vote on the business review. This would result in mechanistic voting with shareholders paying little or no attention to the content of the review or the quality of reporting. There are already established processes in place for shareholders to raise concerns with the board or to vote against the reappointment of the chairman if they do not agree with the way in which the company is being run. The emphasis should be on encouraging constructive engagement between shareholders and boards and not on introducing more mechanistic procedures.

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

The AIC does not believe that an awards scheme would improve the quality of narrative reporting. Companies are more likely to be persuaded to improve

their disclosures as a result of pressure from shareholders rather than the desire to win an award.

14. Do the current disclosure requirements provide clear and usable information about:

- **the total remuneration paid to directors, and how this is made up;**
- **the performance criteria for payments to directors, and how these relate to the company's strategic objectives;**
- **company performance against these criteria, so that there is a demonstrable link between pay and performance;**
- **the process by which directors' remuneration is decided?**

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

The vast majority of investment company boards are made up of non-executive directors and therefore most of the disclosures in the Directors' Remuneration Report are not relevant.

The AIC believes that it is useful for the company to set out the process by which directors' remuneration is decided. It is worth noting the overlap between the Directors' Remuneration Report requirements and the UK Code which takes a principles-based, 'comply or explain' approach to disclosing policies for setting director's remuneration.

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.

The AIC has no specific information on the costs of preparing narrative disclosures. However, where the reporting framework can be reduced or simplified, this will decrease costs and free up company resources to concentrate on more critical business issues.

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