NAPF
Securing the future of pensions

## Department for Business, Innovation and Skills
# The future of narrative reporting – a consultation

# NAPF Response October 2010

## Introduction

The National Association of Pension Funds (NAPF) represents the interests of UK occupational pension funds with assets in excess of £700bn. The NAPF has a role in ensuring institutional investors are well equipped to make informed investment decisions, and this is aided by having access to adequate and meaningful information on the companies in which they invest.

When assessing the issues associated with the current narrative reporting framework, it is important to first address whether or not there is in fact a problem with the framework and its application by companies. There are many companies who report to an excellent standard, providing shareholders with a meaningful and holistic view of the company. There are, however, a number of laggards who report only to a level of bare compliance with reporting regulations. To this end, whilst some companies do report to an exceptional standard, the NAPF believes that, overall, there is room for improvement. The NAPF therefore welcomes this opportunity to respond to the Department for Business Innovation and Skills' consultation: *The future of narrative reporting*.

## Value of narrative reporting

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

Narrative reporting often tends to focus on past events, rather than setting the forward-looking strategy and principal risks. This is possibly due to the backward looking nature of financial reporting, and an effort by the company to correlate the narrative with the financial results. Effective narrative reporting should provide the reader with a clear view of the company's business and strategic direction. Ideally, narrative reporting should provide a clear statement as to the company's objectives and how it plans to achieve them, as well as the key risks associated with the strategy. This should be in addition to disclosure of performance against its objectives over the reported year, and the longer term.

Many companies see the annual report as a marketing document; and many see it as a compliance exercise. The NAPF believes that reporting should be seen as neither marketing nor compliance – rather, it should present a balanced view of the company in its own words. Unfortunately, not all companies achieve effective narrative reporting, and the NAPF recognises that getting the report's balance right can be difficult.

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

The most important constraint arises from directors' concerns that the provision of forward-looking information which proves to be wrong or misleading could expose them to legal redress. It is important that companies are able to provide their shareholders with relevant information without taking that risk. Section 463 of the Companies Act 2006 provides that a director will be liable to compensate for any loss suffered as a result of an untrue or misleading statement in the directors' report, the remuneration report or the summary financial statements. It also provides a 'safe harbour', whereby a director will only be liable in relation to statements which are known to be untrue or misleading or if there was a deliberate attempt to conceal a material fact. The NAPF believes that more clarity is required from the Government as to when and how this section of the Act is likely to be enforced, as this could be an important factor in improving the quality of reporting across the board.

Another key difficulty with narrative reporting is balancing the requirements of different stakeholders and having an understanding as to the report's audience. As a result, companies often attempt to report to too many stakeholders and the size and scope of the report becomes a major concern. One of the key challenges for companies is to create reporting that meets the necessary regulatory requirements, whilst effectively informing shareholders and other stakeholders.

A further constraint on companies providing forward looking information and principal relates to potentially sensitive information. Shareholders do not expect companies to report on all aspects of their corporate strategy, and are typically understanding of the difficulties companies face with respect to legal requirements, or competitive advantage. The challenge for companies is to report information which is material and relevant to the stakeholders, and which is genuinely informative and forward-looking.

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

It is difficult for investors, as outsiders, to know whether or not a company's reporting reflects boardroom discussions. Certainly, the NAPF would hope that material issues discussed in boardrooms are duly reported to stakeholders via the annual report. The NAPF hopes that companies will respond to this question and that this will enable investors to gauge the depth and extent to which particular issues are considered.

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

It is important to recognise that narrative reporting provides only an element of a company's reporting process. The reporting and disclosure process is complex, and much of the valuable information shareholders require is provided to them throughout the year, by way of meetings, presentations and interim results. However, the annual report, and the narrative reporting provided within it, should ideally provide the reader with a holistic picture of the company – including both forward and backward looking information – allowing them to make a considered judgement of the company.

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 NAPF engages in regular dialogue with quoted companies, and this includes engagement on issues such as disclosure and transparency. Where engagement on such issues fails, the *NAPF Corporate Governance Policy and Voting Guidelines* recommends voting sanctions that a shareholder may wish to pursue in the event of poor or non-disclosure of material information.

In 1990, the Financial Reporting Council (FRC) established the Financial Reporting Review Panel (FRRP), which looks to ensure that financial information provided by companies is compliant with the relevant accounting standards. Report users are able to report inadequate reporting to the FRRP who will approach the company in question for further information or explanation. The FRRP reported in its 2010 annual report that there is an increasing interest in narrative reporting and that information requests to companies often included concern regarding inconsistencies between the narrative information at the front of the report (the 'front end') and the financial information at the back (the 'back end'). The NAPF sees this type of enforcement and oversight as a valuable part of the journey towards effective reporting.

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)?**

The NAPF engages in direct dialogue with companies on behalf of its institutional investors, and this is where much of its information is gathered.

The use of electronic reporting has developed extensively in recent times, and this has been of great benefit to report users. The ability to search electronic reports for key words and phrases is important, as is the use of hyperlinks directing the user to routine 'boilerplate' reporting, thus reducing clutter in the report.

Companies should make full use of their website, as it is a fast and effective means of reaching stakeholders. It is easily accessible and enables the company to provide regular updates on its activities. If companies do elect use their website as a means of reaching stakeholders, they need to be certain that the website is easy to navigate. Whilst many companies have useful and informative websites, there remain many who do not use the website effectively, either due to simply not making information available, or by having information which is difficult to find.

With respect to other forms of reporting (such as corporate social responsibility or sustainability reports), these can certainly provide useful information on, for example, social, environmental or human capital risks. However, if these risks are considered to be material and relevant to the company, then one might argue that this information should be reported in the annual report rather than a stand-alone document. Companies should take a holistic approach to reporting on risk, risk strategy and targets, and performance, and material risks (whether financial, social, environmental, governance or other risks) should be reported consistently.

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

With respect to narrative reporting, companies should report on objectives, performance and risks which are relevant and material to their individual circumstances. The danger with setting prescriptive requirements on which companies report is that in order to become relevant for all companies, the requirements may become too high level, and therefore not useful for making investment decisions. The current regime has not been produced particularly coherently, and has lead to a situation where many reports contain too much irrelevant and immaterial detail, or clutter. There is certainly scope to 'cut the clutter', and this has been recognised by the FRC, through the FRRP.

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

Companies should take notice of shareholders' requirement for consistent and comparable information to assist them to make investment decisions. Reports should be structured in a way that makes them clear and concise so that shareholders can easily extract the information they require.

The NAPF considers that better layout and formatting of reports would be useful. To this end, the NAPF is supportive of initiatives such as that of the International Integrated Reporting Committee, which aims to "create a globally accepted framework for accounting for sustainability: a framework which brings together financial, environmental, social and governance information in a clear, concise, consistent and comparable format".

## Business review

**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 Enhanced Business Review captures many (in fact, most) of the elements of the Operating and Financial Review (OFR). The OFR was certainly a useful tool for the provision of best practice guidance, and it remains so, however it does not necessarily need to become a statutory requirement. Whether or not the OFR were to be reinstated, the ASB's reporting statement RS1 should be updated to ensure it remains current and relevant.

The NAPF does not believe that a statutory reporting standard would necessarily help to improve the quality of reporting. A statutory reporting standard may lead to a tendency toward boilerplating, which would not encourage companies to report on information that is relevant and material. A degree of flexibility as to what and how companies report is important, as it allows for the use of judgement. However, companies should not take advantage of such flexibility, and must ensure that the annual report is not treated simply as a marketing exercise.

**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**

1. **Is this information useful to you? How do you use it?**
2. **Could disclosure be improved?**
3. **Are there key issues which are missing? If so, please explain.**

With respect to conflicts of interest (fourth dot point), companies are already required to report on this as determined by companies law, and therefore companies should already have a direct focus on this issue.

The remaining provisions highlighted in this question are very much at the discretion of the board as to how much or how little is reported. Some companies report on this information well, some report only the bare minimum to satisfy the requirements of the provisions, whilst others report extensively, often providing more information than is required for stakeholders and resulting in reports that are simply too big and not fit for purpose. In order to ensure reporting is effective and useful, companies should be encouraged to explain how they measure and record the materiality of issues to the business.

As corporate governance specialists, this data is helpful to the NAPF in assessing the overall standards of governance at a company. The key to good disclosure is a focus on exceptions or unusual features of the reporting.

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

Companies are likely to benefit from guidance on reporting. This could be in the form of best practice examples or key performance indicators, such as those of the Global Reporting Initiative[1], or the DVDA/EFFAS KPIs for ESG[2]. In any case, anything that is reported, and the way it is presented, needs to be relevant to the company and must relate back to its stated strategic objectives.

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

The NAPF believes that whilst there should not be a statutory requirement, an advisory vote may be useful. It gives companies the flexibility to report in a way that is meaningful to their business, but it also allows shareholders to monitor those who are taking advantage of such flexibility by providing inadequate disclosure. In order for an advisory vote to be effective, it would need to be coupled with effective engagement to ensure the company understands the requirements of the shareholders and the rationale for an adverse vote.

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

The NAPF believes that an advisory vote on the Business Review, coupled with effective engagement, may lead to increased quality in reporting. The NAPF also sees merit in publicising excellence in business reports in order to raise awareness as to what is considered to be best practice in reporting. Already in existence is the ICSA/Hermes Transparency in Governance Awards, and there may be scope for the FRC, via the FRRP, to publish a report on their results, highlighting companies who report to a high standard. The NAPF is supportive of a 'name and fame' approach, as opposed to a 'name and shame' approach.

[1] http://www.globalreporting.org/Home

[2] http://www.dvfa.de/files/die_dvfa/kommissionen/non_financials/application/pdf/KPIs_ESG_FINAL.pdf

## Directors' Remuneration Report

**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; and**
- **the process by which directors' remuneration is decided?**

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

The Remuneration Report should provide full disclosure of the key components of remuneration.

There are often weaknesses around demonstrating the link between pay and longer term performance (for example the value of shares or options vesting in a year is seldom aggregated with other pay and the rewards linked back to the performance of the business and the shares). It would be useful if companies were to provide the value of outstanding awards at one point in time, as it would allow shareholders to understand the value of outstanding awards, as well as allowing beneficiaries to gain a clearer understanding of the monetary value of awards outstanding. In addition, there is often excessive focus on peer benchmarking and too little on the job itself.

With respect to the performance criteria for payments to directors, company performance against the criteria and the process by which remuneration is determined, the disclosure of such information is fundamental for shareholders to gain an understanding of how directors are incentivised to generate returns. Shareholders must be able to assess performance criteria to the extent that they can make a judgement about the link between pay and performance.

The NAPF would be supportive of a recommendation that companies fully explain how and why the performance criteria are chosen, and how this links to the company's strategic objectives. Further, this recommendation could be strengthened by requiring that companies better explain specific linkages between the overall performance of the company and the achievement of the performance criteria. Thorough explanations of the links between pay and performance should ultimately enable the shareholder to understand the process by which directors' remuneration is decided.

## Potential Costs

**15. If you can provide any information on costs associated either with the existing narrative reporting requirements (e.g. 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 NAPF considers that companies are better placed to provide a thorough answer to this question. However, the NAPF believes that much of the required information would already be available for internal reporting and management purposes and so companies should not use cost alone as means for justifying inadequate reporting.

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