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Response to BIS consultation on the future of narrative reporting

The City of London Law Society ("CLLS") represents approximately 13,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response in respect of the BIS consultation on the future of narrative reporting and has been prepared by the CLLS Company Law Committee. The Committee's purpose is to represent the interests of those members of the CLLS involved in company law and related regulation.

Overview

We believe that the quality of narrative reporting has improved significantly in recent years. While this has resulted partly from changes to the requirements to which companies are subject it has also, possibly to a greater extent, been driven by the demands of investors and other stakeholders. We strongly believe that further improvements can be facilitated by appropriate regulation such as the liability regime in section 463 of the Companies Act 2006 (a good example of regulation that has facilitated better reporting) and through softer measures, namely pressure from investors and others and clearer guidance.

We respond to the consultation questions as follows (and on the basis that the questions refer to listed companies):

Value of narrative reporting

1. Are company directors providing useful and relevant information on the company's:

(i) forward-looking strategy?

We believe that directors generally recognise and take seriously the need to comment on strategy, although we note that this has not until recently been a formal requirement (see below). It is not for us to comment on whether investors find the information useful or relevant. We do however, note that in the Accounting Standards Board's 2009 publication *Rising to the challenge – A review of narrative reporting by UK listed companies* (which contains a very useful assessment of the quality of narrative reporting by listed companies), they say (page 3):

"Most companies are providing a good standard of information in their financial reviews, the description of objectives and strategies, and the provision of financial key performance indicators."

We would also note that the annual report may not be the most important statement of strategy made by a company. Many larger listed companies provide separate updates on strategy during the financial year, at a time when investors have the opportunity to concentrate on the messages being conveyed. Any assessment of companies' communication in this area should therefore look at the whole range of communications made by listed companies.

As noted above there is no specific requirement for companies to report on strategy in the business review required by Section 417 of the Companies Act. The Disclosure and Transparency Rules (DTRs) require the annual management report of a listed company to comment on its *"likely future development"*.

The June 2010 version of the UK Corporate Governance Code, which applies to premium listed companies with accounting periods beginning on or after 29 June 2010, contains a new Code Provision C.1.2 which requires directors to include in the annual report *"an explanation of the basis on which the company generates or preserves value over the longer term (the business model) and the strategy for delivering the objectives of the company"*. The Listing Rules require premium listed companies either to comply with such a provision, or to explain why they do not. There is no equivalent provision in the earlier Combined Code which applies to accounting periods beginning before 29 June 2010.

(ii) principal risks and uncertainties?

Section 417(3)(b) of the Companies Act 2006 requires the business review to include "a description of the principal risks and uncertainties facing the company".

It is not for us to comment on whether investors find this information useful or relevant. However, the ASB's 2009 review Rising to the challenge (referred to above) again provides an assessment of the standard of reporting in this area. It notes that:

"there are significant opportunities for improvement in the reporting of principal risks, trends and factors, contractual and other arrangements and non-financial KPIs."

The ASB said that it expected greater discussion of liquidity risk, given the current economic environment, and also reported finding "immaterial clutter" in the risk reporting sections of the narrative.

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

We would identify the following constraints:

Time and cost: the ASB review Rising to the challenge says (page 1):

"Preparing a good quality annual report that communicates effectively all the important information is a major intellectual and logistical challenge."

It must be recognised that, while the very largest companies may have the resources to devote to this exercise, smaller and medium sized companies may not. Additional regulation in this area will not help those companies to comply.

Complex regulation: the ASB also comments (on page 3)

"where companies are struggling to report, it could be due to a lack of clarity of the requirements."

The Financial Reporting Council's 2009 report Louder than words – *Principles and actions for making corporate reports less complex and more relevant* also commented that:

"corporate report preparers almost unanimously said the process of compiling a report is too complex, and so are the reports themselves."

There are often multiple sources for regulations which are repetitive or over-lap. For example, in the area of risk and internal controls:

- the Business Review has to contain a description of the principal risks and uncertainties facing the company (s.417(3)(b), Companies Act 2006).

- the DTRs require a description of the main features of the internal control system as it relates to financial reporting (DTR 7.2.5R).

- International Financial Reporting Standard 7 requires companies to set out in their audited accounts how they manage financial risks and a summary of the information that key operating decision makers use to manage those risks.

Confidentiality: it should be recognised that questions of strategy can be confidential and premature disclosure can create an advantage for a company's competitors. As a result, companies often resort to more general descriptions of strategy while plans remain confidential.

Liability: it is recognised that section 463 of the Companies Act 2006 limits as well as prescribes the extent of the liability of directors for false or misleading statements in the directors' report including the business review. It does not seem to us that the potential for personal liability on the part of directors constrains reporting by companies on these issues. In our experience directors are more concerned about the (hindsight) judgments that the market may make, which may incline them to caution in their statements about strategy.

Rules on profit forecasts: listed companies are materially constrained in their willingness to provide meaningful forward-looking financial information by the requirements in the Prospectus Rules, the Listing Rules and the

Takeover Code that in certain circumstances will require profit forecasts published as part of regular reporting to be repeated (in circumstances where the directors face personal liability without the benefit of the protections provided by section 463 of the Companies Act 2006) and reported on by independent accountants. As a result many companies take care to avoid express forecasts but instead rely on coded comments. It may be time to review the pressures that led to this result and consider whether a regulatory environment more conducive to useful and carefully prepared forward-looking statements might not provide better information to shareholders and other stakeholders.

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

In our experience the information provided on strategy reflects the board's internal conclusions. It is nonetheless important that directors should feel free to engage in frank discussions on strategy in the boardroom without a consequent need to reproduce those discussions in the annual report. It is sometimes the case that the information given on risks may identify many risks that are not central to the directors' assessments of the main risks faced by their companies.

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

The UK Corporate Governance Code and the new Stewardship Code encourage effective engagement between directors and shareholders on matters of concern to each. Code Provision E.1.1 says the company chairman should discuss strategy with major shareholders. The Supporting Principle to Main Principle E.1 says that all directors should be aware of their major shareholders' issues and concerns. If these terms of the Code and the Stewardship Code are complied with, we believe there should be sufficient dialogue on these issues between directors and shareholders.

It is our understanding that major institutional shareholders of listed companies are more likely to base their investment decisions on direct dialogue with key members of the board combined with analyst's reports, rather than as a result of the content of the business review. This is perhaps unsurprising given that the financial statements of listed companies only appear once a year and can quickly become out of date in light of subsequent market and economic developments. The DTRs are designed to ensure that all market participants have access to appropriate information to make investment decisions about a listed company (and that the dialogue referred to above does not provide any more information than is available in the market).

We do not comment further on what might motivate shareholders' business decisions.

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?

This question is aimed at investors and we do not comment on it.

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)?

This question is aimed at investors and we do not comment on it.

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

Please see the comment on complex regulation in answer to question 2 above. We believe that such complexity discourages clear and informative narrative reporting. The imperative for a company to ensure compliance with all disclosure requirements can easily obscure the overall aim of good narrative reporting. A company's first obligation will inevitably be to comply with each statutory or regulatory requirement (for fear of sanctions for failure to do so); the wish for clarity and informative narrative may, as a result, be a secondary concern. A simpler and more coherent approach to regulation may allow for more emphasis on good narrative reporting and less on “box-ticking” compliance.

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

Legislation and regulation in this area should not be over-prescriptive. How required information is set out in a report should be left to the good sense of companies themselves, assisted by available guidance. The guidance provided by the ASB review *Rising to the challenge, the FRC's Louder than words and the ASB's 2006 Reporting Statement: Operating and Financial Review* is very useful. Unlike legislation, it is flexible and capable of developing to meet changes in practice and shareholder requirements.

We do not see introducing a requirement for companies to publish a summary of the information contained in the business review as an appropriate response to counteract its growing complexity. Producing such a summary is a material additional burden and is likely to lead to over-simplification of issues that are complex.

Business Review

9. Looking at an Operating & Financial Review and the existing business review, 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?

Paragraph 23 of the consultation document notes that "the business review requires companies to provide broadly the same information on non-financial matters as the earlier OFR." We do not see any value in reinstating elements of the OFR. (We assume that, as in 2005, this would only apply to quoted companies.) Any move to do so would, we believe, need very clear justification and evidence that it is required by shareholders and/or regulators. In that context, we note the following comments in the reports already referred to:

"As we began [investigating the complexity and relevance of corporate reporting], the unfolding credit crisis raised an additional issue: the risk of

further complexity arising from uncoordinated responses to the crisis by regulators and standard setters." FRC's *Louder than words* (page 2)

"Our research has convinced us that the best route to better reporting – and regulation of reporting – emphasises principles rather than rules." FRC's *Louder than words* (page 5)

"We must consider whether further [carbon reporting] requirements in the business review will succeed in changing company behaviour or just in adding clutter to an already heavy annual report." ASB's *Rising to the challenge* (page 12)

Companies are currently getting to grips with the revised UK Corporate Governance Code and the new Stewardship Code. Some of the provisions in the Companies Act 2006 which impact on company reporting remain relatively new and have not applied for more than one or two accounting periods. And the guidance referred to above dates from 2009 and is still being digested and applied. These various influences on the contents of company reports should be allowed to settle down and be properly assessed before any new regulation is imposed.

Nor do we believe that there is any evidence that a statutory reporting standard would improve the quality of reporting. In our view improved narrative reporting can be achieved through guidance, example and shareholder pressure. A statutory standard implies an OFR that has to be subject to a costly review by the company's auditors, the requirement for which is likely to discourage the openness and transparency of reporting.

10. The business review provisions require quoted companies to report, to the extent necessary, on [the matters set out in section 417(5) of the Companies Act 2006]:

(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?

These questions are aimed at investors and we do not comment on them beyond reiterating our views in answer to question 7.

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

The guidance referred to in answer to question 8 is very useful. The ASB and the FRC should be allowed to develop and enhance that guidance over time. We do not see a particular need for an additional source of guidance, and there is danger in possible conflict between different sources of guidance.

Investors will also provide their own direct and indirect feedback to companies. If a company's strategy is not clear, if it fails to explain the risks it faces and how it manages them, or if its corporate social responsibility policies are thought deficient, shareholders can either bring pressure to bear on the company through contact with directors and at the AGM, or they can decide to reallocate their resources to companies which they think deal better with these issues. If these reporting requirements are largely for the benefit of shareholders, the company's owners have a role to play in encouraging best practice and taking action where that is not provided.

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

We do not see any benefit in a shareholders' advisory vote on the business review. There is already a vote on the report and accounts which include the business review.

What would be the consequences of a vote against? If there are no set consequences, what is the point? Shareholder dissatisfaction can be made clear in other ways, either informally or by a vote against the resolution to receive the accounts or a vote not to re-elect a director. Adding to the number of votes at an AGM which have no real consequence risks downgrading the power and effect of a shareholder vote.

We would also point out that, with the advisory resolution on the directors' remuneration report, the need to grant the right to call general meetings on not less than 14 clear days' notice and the requirement for all directors to seek annual re-election, the number of resolutions at an AGM often approaches 20. Further crowding of the AGM agenda does not assist clarity with shareholders. For the reasons identified above we believe investors will engage with companies where they consider the business review is deficient and the shareholder vote is not required as an extra lever for this purpose.

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

See our comments in answer to question 11 on the provision of guidance.

The ICSA Hermes Transparency in Governance Awards play a valuable and developing role in promoting best practice. If there is an appetite amongst companies and their shareholders for other such awards, they will no doubt appear.

We would not favour any government sponsored award or ranking, as seems to be suggested in paragraph 30 of the consultation document.

We also see a slight risk in awards and similar proposals placing too much emphasis on what the report says, rather than on what a company actually does and then reports on.

Directors' Remuneration Report

14. Do the current disclosure requirements provide clear and usable information? If not, please explain including any views on how this might be improved?

We do not believe there is a requirement for any more information on directors' remuneration. Instead, it would be desirable for the disparate sources of legislation and regulation in this area - the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, the UK Corporate Governance Code, the Listing Rules and the FSA

Remuneration Code, itself under review, with further rules announced by the Committee of European Banking Supervisors - to be brought together in one readily accessible code.

As a consequence of these many rules, remuneration reports have grown in length. Guidance, of the type discussed above, can play a role in the better ordering of information in the report to aid clarity and understanding. An exercise similar to that carried out by the ASB in Rising to the challenge would be of help in highlighting good examples of clear and usable information.

Potential costs

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.

We do not have information on such costs, beyond pointing out that further legislation or prescription in reporting is likely to add to the costs of compliance for companies.

If you wish to discuss any of the above points, please contact Martin Webster of Pinsent Masons LLP, on 0207 418 9598 or martin.webster@pinsentmasons.com.

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