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FairPensions Response to Draft Regulations on Narrative Reporting

FairPensions welcomes this opportunity to comment on the government's draft regulations on narrative reporting.

In brief, our key recommendations for amendments to the regulations are:

1) Move the requirement to report on the company's strategy and business model up from section (4) to section (2). This is not a cosmetic change but is, in our view, crucial to the coherence and effectiveness of the new reporting framework.
2) Require companies who choose not to report any information on environmental, employee, social, community or human rights issues to explain why, in their view, this information is not necessary for an understanding of the business.
3) Reinstate the requirements to report on charitable donations and on policy and practice in relation to payment of creditors.
4) Confirm that companies will be required to lay the strategic report before their Annual General Meeting. We also suggest that the government might clarify its expectations regarding shareholder votes on the content of the strategic report.

General comments

The government's review of narrative reporting was prompted by a commitment in the coalition agreement to "*reinstate an Operating and Financial Review to ensure that directors' social and environmental duties have to be covered in company reporting and investigate further ways of improving corporate accountability and transparency*".

As we have previously indicated, we are disappointed that the focus on improving environmental and social reporting has been lost during the course of the review. It remains our view that – with the notable exception of the explicit inclusion of human

THE CHARITY AWARDS 2012 HIGHLY COMMENDED rights – the present draft regulations essentially replicate the existing position on environmental and social reporting, and are unlikely to do anything to drive up standards in this respect. We would therefore urge the government to consider other ways to improve environmental and social reporting in order to deliver on its coalition commitment.

More generally, it is unclear to us how the proposed new reporting framework will differ substantially from the existing framework, particularly given the decision to abandon the Annual Directors' Statement. We had understood that the Strategic Report was intended to be a shorter, more focussed document underpinned by more detailed, primarily online disclosures. There is nothing in the new regulations which is likely to make Strategic Reports shorter and more focussed than the Business Review, but in some ways this is not surprising. We have always argued that the proliferation of long and complex reports is not a consequence of excessively prescriptive regulation but rather a result of the way companies choose to report.

Below we offer specific comments on the detail of the regulations. We also offer some thoughts about next steps to support the new regulatory regime.

Strategy and business model

We are somewhat confused by the inclusion of the provisions relating to strategy and business model in section 414C(4) of the proposed regulations. Since these are at the heart of what the new strategic report is intended to be about, we would suggest that these provisions would fit far more logically into section (2), for example as follows:

> *" (2) The strategic report of the company must contain-*
>
> *(a) a fair review of the company's business,*
> *(b) <u>a description of the company's strategy and business model</u>, and*
> *(c) a description of the principal risks and uncertainties facing the company."*

Alternatively, this could be incorporated into section (3) (which details what the 'review' of the company's business' must cover).

Insofar as the strategic report differs in focus from the business review, it would seem to make sense for this new focus to be incorporated into the regulations which set out the core content of the report, rather than in the subsequent provisions about what specific types of information this might include.

In particular, there are two important problems with including these provisions in section (4):

- This would mean that strategy and business model would only have to be reported on 'to the extent necessary for an understanding of the development, performance or position of the company's business'. This could create confusion by giving the impression that reporting on strategy is an optional extra rather than the core purpose of the new report, with the company being allowed to decide the extent to which it was appropriate for it to report on strategy. It would also imply that strategy is one item amongst many to be 'ticked off' in the course of the report, as opposed to the overarching focus towards which the entire report should be directed. This would clearly undermine the intent of the new provisions.

- The inclusion of strategy & business model and environmental & social issues as items in the same list implies that they are two entirely separate matters or 'headings' within the report. This could perpetuate the current tendency to report on environmental & social matters in isolation from company strategy, rather than encouraging a move towards more integrated reporting. Moving the provisions on strategy & business model to section (2) or (3) would make clear that the list in section (4) comprises factors which companies should include *in the course of* their overarching discussion of company strategy, rather than add-ons to be discussed in isolation from strategy.

Environmental and social information

Human rights
We welcome the government's decision to include an explicit reference to human rights in the new regulations.

Explanations where companies choose not to provide information
We would suggest that the last sentence of section 414C(4) be amended to read:

> *"If the report does not contain information of each kind mentioned in paragraphs (d)(i),(ii) and (iii), it must state which of those kinds of information it does not contain* *and why, in the directors' opinion, such information is not necessary for an understanding of the development, performance or position of the company's business."*

In line with the approach taken in other areas of UK corporate governance, it seems reasonable and appropriate to ask companies who choose not to apply the requirements of section 414C(4)(d) to explain why these are not relevant to their business model. Given the government's original commitment to strengthen environmental and social reporting, this would seem to be a reasonable and proportionate step to signal the importance the government attaches to this and its desire for companies to take seriously the flexibility provided by the reporting regulations.

Non-financial KPIs
We note that non-financial KPIs are the single largest area of non-compliance with the law identified by the Accounting Standards Board, with around a third of companies failing to comply with the law and a further 20% falling short. Since the government proposes not to change the content of the regulations regarding non-financial KPIs, we would stress that it is vital that stronger guidance is provided on this matter.

Proposals to remove certain reporting requirements

Payment of creditors
We are aware of several institutional investors who have expressed concerns about the removal of this requirement. For instance, Aviva in its response to the government's previous consultation observed that late payment of creditors is "*a useful pointer on the creditworthiness of the company*", concluding "*we believe this is material information.*"

We note the government's conclusion that "*the information this requirement provides is not considered useful for either creditors or shareholders*". If the government accepts Aviva's argument that this information would be useful, but contends that companies are not in practice providing it, the solution must surely be to improve guidance and/or enforcement rather than to remove the requirement altogether.

This would also be consistent with the government's approach to reporting on employee engagement. One of the arguments for removing this requirement was that many companies were not in practice providing meaningful information. However, the government rightly concluded that "*given the importance the Government attaches to encouraging employee engagement"* it would not be appropriate to remove the requirement. We find it difficult to see why the reverse approach has been applied to late payment of creditors despite the recognition that *"successive governments have attached a great deal of importance to prompt payment to creditors by business."*

In particular, given the government's recent announcements regarding the 'naming and shaming' of businesses who do not sign up to the Prompt Payment Code on payment of suppliers, removing this requirement now would send conflicting signals about the government's priorities.

Charitable donations

Again, we note that several investors and NGOs have opposed the removal of this requirement. On balance, we agree that transparency in this area is valuable and important – both for shareholders to assess whether donations are an appropriate use of corporate funds, and as a means of uncovering potentially dubious practices involving donations to charitable entities linked to the corporation or its senior executives.

We believe the government has misjudged the views of report users on these two issues and urge that the removal of these requirements be reconsidered.

Shareholder votes

At present, companies are required to lay their reports and accounts before their members, usually at an Annual General Meeting, and it is standard practice to allow shareholders a vote to receive the Annual Report & Accounts. This provides investors with an opportunity to register concern if they believe the company's account of its strategy and performance to be inadequate.

Given that the government proposes to make the strategic report a separate document rather than a part of the director's report, it is not clear whether shareholders will be given the opportunity to discuss and vote on the strategic report at company AGMs. Effectively restricting investors to voting on the financial statements would be a step backwards, potentially reducing rather than enhancing the focus on company strategy in shareholders' dialogue with companies.

It would therefore be helpful if the government could clarify that the requirement in section 437 of the Companies Act 2006, to lay the company's reports before the AGM, will also apply to the strategic report. It might also clarify whether it expects that companies will continue to hold a vote on the content of the strategic report, either together with the vote on the Annual Report or in the form of two separate votes.

Future steps

Statutory reporting standard
We note the government's plan to proceed with updated voluntary guidance to be issued by the Financial Reporting Council. We are disappointed that the government appears to have rejected the possibility of issuing a statutory reporting standard and would urge that this be reconsidered, for the reasons outlined in our previous submissions.

Financial Reporting Review Panel (FRRP)
In addition to guidance, it is critical that steps be taken to improve the effectiveness of enforcement. Accounting Standards Board research shows high levels of non-compliance with existing reporting obligations, which the draft regulations substantially replicate. Unless this is addressed, the government will not succeed in its objective to raise standards of reporting.

In order to do this, the FRRP must be properly resourced, contain a sufficient range of expertise, enhance its independence from industry and become more transparent and robust in its procedures for investigating reports and dealing with complaints. For more on this please see our previous submissions.

We would welcome the opportunity to meet with you to discuss the issues raised in this response. Should you have any queries, please do not hesitate to contact me.

Yours sincerely,

Christine Berry

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