FairPensions™ The campaign for **responsible** investment

ClientEarth Justice for the Planet

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Dear Mr Haddrill

FairPensions & ClientEarth joint response to FRC Paper: 'Effective Company Stewardship'

FairPensions and ClientEarth welcome this opportunity to contribute to the FRC's thinking on enhancing corporate reporting and audit. FairPensions is a registered charity established to promote Responsible Investment (RI) by pension schemes and fund managers, and to ensure that ultimate beneficiaries are well served by institutional investors and other professional agents in the investment world. It is a member organisation whose members include various organisations representing pension savers, including the National Federation of Occupational Pensioners, UNITE and Unison, as well as thousands of individual pension fund members. ClientEarth is a non-profit environmental law organisation based in London, Brussels and Warsaw.

We are pleased that the FRC is exploring this important area and welcome many of the proposals in the document. The discussion below builds on the points raised in our responses to the government consultation *'The future of narrative reporting'*, available on our websites at www.fairpensions.org.uk/policy and www.clientearth.org/reform-in-the-uk-the-operating-and-financial-review respectively.

General principles: fair, balanced and meaningful

We welcome the FRC's emphasis on the requirement for the Annual Report to provide a fair and balanced view of their stewardship of the business. We share the FRC's concern that narrative reports *"should not be promotional in nature, a fault seen in some narrative reporting"* (page 10). The FRRP's recent investigation of Rio Tinto's 2008 Annual Report, which presented a one-sided view of the company's impacts that omitted important information about environmental and social risks to the business, is an illustration of this problem.[1]

[1] http://www.clientearth.org/reports/clientearth-submission-to-frrp-re-rio-tinto-annual-report-2008.pdf, http://www.frc.org.uk/frrp/press/pub2539.html

We also agree that the regulatory framework must seek to promote meaningful reporting rather than *"allowing or encouraging boiler-plate."* Again, environmental and social reporting can in our experience be a particular area of weakness in this regard. Many firms report in general terms about their commitment to sustainability and good corporate citizenship, but are silent on many of the specific environmental and social issues that are material to their business. Again, the recent case of the Rio Tinto report provides a good example.

We urge the FRC to stress the objective standards of care, skill and diligence required of directors when preparing company reports, and to clarify that it is against this standard that the compliance of reports will be judged; that the test for compliance will be whether the reasonable board of directors, exercising reasonable care, skill and diligence as defined by section 174 Companies Act 2006, would have considered the narrative reports to contain a fair review of the business and a balanced and comprehensive analysis of the development and performance of the company's business during the financial year, and the position of the company's business at the end of that year.

Further, we are not convinced by the argument that compliance concerns are the only factor restricting companies from providing a more honest and meaningful picture of their business in narrative reports. Accordingly, although we agree that removing 'clutter' from narrative reports would aid businesses, investors and other report users, we do not believe that simplification of the regulatory framework – the approach highlighted in the government's recently-published Plan for Growth[2] – will by itself achieve the desired improvements.

The need for guidance and clarity on legal requirements

We believe that a key factor undermining the quality of narrative reporting is the continuing lack of guidance or certainty about what constitutes adequate reporting and compliance with the law. Although the FRRP's recent action in relation to Rio Tinto's 2008 Annual Report was welcome, it is disappointing that the FRRP made no statement about whether the enhanced disclosures in Rio Tinto's 2010 Annual Report were considered to be required by law, or whether the 2008 Annual Report was considered to be compliant with the law. This absence of transparency means that even in the rare cases where complaints are brought and enforcement action is taken, interpretation of the law is not advanced.

The Accounting Standards Board's 2009 review of narrative reporting is more helpful in this respect, since it sets out criteria against which to assess compliance with the letter and spirit of the law, and provides an estimate of the number of reports meeting these standards. Although ClientEarth has reservations regarding the ASB's interpretation of the legal requirements, believing it to be insufficiently demanding, it is striking that even under the ASB's criteria a high percentage of reports were deemed to be 'non-compliant' or 'falling short' (as indicated on p8 of the discussion document). The ASB's full report could provide a starting point for more active efforts by the FRC to

[2],HM Treasury, Plan for Growth, para 2.147, http://cdn.hm-treasury.gov.uk/2011budget_growth.pdf

clarify legal requirements and educate market participants about the application of the law.

In this context, we very much welcome the FRC's proposal for a new Narrative Reporting Standard. We note that the government's Plan for Growth does indicate that *"improving non-regulatory guidance"*[3] may form part of its ongoing efforts to reduce the burden of reporting on business, and we very much hope that BIS will regard the FRC's proposal as complementing this approach.

In order to be effective we believe that any new Narrative Reporting Standard should:

- Give specific guidance on the reporting of social and environmental risks, bearing in mind that these are a key focus of the directors' duties under section 172 of the Companies Act, against which the business review is intended to report; and
- Become the basis for proactive and ongoing efforts at education and enforcement by both the ASB and the FRRP.

See below for more detail on both of these points. For a more detailed discussion of our views on the necessary content of a new Reporting Standard, as compared to RS1, please see our responses to BIS' consultation (in particular page 16-17 of ClientEarth's response).

Social and environmental reporting

We agree with the findings of Black Sun's analysis, reported on page 9 of the discussion document, that "*although the quantity of corporate social responsibility narrative may have increased, the quality of that material is questionable particularly as most do not demonstrate how it is an integral part of their business."* The Gulf of Mexico oil spill is only the latest indication of the relevance of these issues to investors, yet their reporting remains an area of weakness. For example, in a recent analysis commissioned by the Corporate Responsibility Coalition, BP and Rio Tinto were concluded to be among the best-performing companies in the FTSE 100 for non-financial reporting, yet both have recently been the subject of ClientEarth complaints to the FRRP for inadequate or actively misleading reporting.[4]

A large part of the problem with current reporting of non-financial issues is the failure to clearly distinguish between reporting on side-projects aimed at demonstrating good corporate citizenship (such as charitable donations or employee volunteering) and reporting on non-financial issues which are material to the company's business, or indeed among the principle risks to the business (such as environmental regulation, resource scarcity or reputational threats to the company's license to operate). These are two entirely separate strands of reporting, yet often reporting on non-financial issues is relegated to the former with a far from rigorous consideration of the latter.

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[3] HM Treasury, Plan for Growth, Para 2.148

[4] http://www.clientearth.org/reports/clientearth-submission-to-frrp-re-rio-tinto-annual-report-2008.pdf, http://www.clientearth.org/reports/clientearth-referral-to-the-frrp-re-the-bp-annual-report-and-accounts-2009.pdf

In light of this, we are disappointed that the FRC's note on a suggested alternative structure for Annual Reports (page 9) says only that *"CSR matters could be addressed within the above topics or dealt with separately."* This formulation risks perpetuating the 'second-class' status of ESG issues within narrative reports and seems unlikely to resolve the problems the FRC identifies. Our experience strongly suggests that ESG issues will continue to be neglected unless they are given explicit profile by government, regulators and investors. We would therefore caution against the assumption that raising the overall standard of narrative reporting will be sufficient to raise standards of reporting on ESG risks. Rather, there is a need to pay particular attention to these issues in guidance, education or enforcement. We think it is vital for the FRC to provide leadership on the reporting of material environmental, social and governance (ESG) risks, and to encourage 'integrated reporting'.

We also note with interest that, although the ASB did not assess reporting on ESG issues as a separate category, they did find that non-financial KPIs were the single largest area of 'non-compliance' – with 32% of reports non-compliant and a further 20% falling short. This finding suggests that reporting of non-financial KPIs merits special attention from the FRC in order to bring reporting standards up to an acceptable level.

Audit

We welcome the FRC's recognition of the importance of investors having confidence in narrative information. Anecdotally, we hear that one of the key reasons investors do not make greater use of narrative reporting is lack of verification. Indeed, we would argue that a lack of independent scrutiny and verification is one of the most important deficiencies that a new reporting regime must address. At present, the FRRP does not have anything approaching the capacity to scrutinise and verify all company reports. In the absence of regulatory enforcement, the only solution that has yet been suggested is an enhanced audit requirement. In our submissions to BIS' consultation on narrative reporting we expressed the view that the enhanced audit was a key positive feature of the original Operating and Financial Review which the new framework could seek to replicate.

We are therefore disappointed that the discussion paper appears to reject the idea of a separate audit report on narrative information, on the basis that it would undermine directors' responsibility for the management of the company and thereby *"compromise a fundamental principle of stewardship"*. We would not see the role of auditors as entailing any interference with substantive issues about the management of the company. Rather, their role would be to assess the accuracy of information provided in narrative reports, and to identify points of concern that report users might wish to be aware of.

For example, ClientEarth's recent referral of BP's Annual Report to the FRRP focussed on its use of a particular energy demand scenario – the 'reference scenario' – to justify its business strategy. The complaint argues that the use of this scenario is not compliant with the law since the report does not explain the scenario's underlying assumptions: namely, that it is produced by the International Energy Agency purely as a baseline against which to compare different scenarios, and is not a prediction of actual future energy demand; and that it assumes no government action on climate change and a consequent catastrophic 6 degree temperature rise.

This is a clear example of the sort of situation in which auditors should be able to indicate whether information contained in the narrative report is potentially misleading or inappropriate. This would not encroach on the role of management: the auditor would not necessarily take a view on the substantive decision to rely on the scenario in question, but rather on whether the provision of decontextualised information was liable to obstruct shareholders in making an assessment of how the directors have performed their duty to promote the success of the company.

We recognise that forward-looking information cannot be audited in precisely the same way as historical information – for instance, there may need to be a greater focus on the *process* by which reports are compiled. We also agree that *"the training, skills and experience of auditors would need to be substantially enhanced if this approach were to be pursued."* Having said this, we would also note that there is no intrinsic reason to assume that assurance of narrative information must be provided by accountants or be based on the same models as financial audit. It is worth taking a broader approach to the value of assurance: for instance, it may be that the most appropriate people to provide such assurance are experts in the company's field of business or in the issues under discussion, independent of the company, who are able to take an informed view as to whether the information provided is accurate or misleading. Further work is clearly needed in this area, but this is not a reason for neglecting it altogether.

Leaving aside the question of whether enhanced audit is feasible, we agree with the FRC that more could be done within the existing framework to give investors confidence in narrative information. We welcome the FRC's suggestion that auditors should report on any facts or matters in the Annual Report which are inconsistent with the financial statements. We understand that this requirement is already the legal position. However, we agree with the implication that auditors could be encouraged to reinterpret this requirement, moving away from a narrow focus on whether any particular facts are directly inconsistent, and towards a broader assessment of whether the picture painted by the narrative report is inappropriately rosy when compared to the financial statements, or otherwise lacking in fairness and balance. We also welcome the proposal that the Audit Inspection Unit's supervision should extend to the auditor's consideration of the narrative content in Annual Reports.

The FRC's powers and independence

If it is felt that audit does not provide a satisfactory solution for the assurance of narrative reporting, it becomes all the more crucial that the regulator is able and willing to take a proactive and rigorous approach to monitoring and enforcement, to give shareholders confidence in the quality of reporting. We therefore welcome the proposals for the development of the FRC's responsibilities to ensure it is fully equipped to fulfil this role. We consider these proposals to be of utmost importance.

As indicated above, we consider that a review of the FRRP's approach to enforcement is particularly crucial, especially with respect to the transparency with which it conducts and concludes its enquiries.

We also welcome the FRC's suggestion that measures could be taken to reinforce its independence. Independence both from regulated entities and from government is vital to robust and effective regulation. We look forward to seeing the FRC's more detailed proposals as to how its independence might be enhanced. In this regard we would also caution against the risk that the proposed 'market practitioners' forum' could have the opposite effect, by more deeply embedding the interests of regulated entities in the regulator's approach whilst exacerbating the 'outsider' status of other stakeholders, such as report users, beneficiaries and civil society organisations. We refer to FairPensions' proposal, in relation to the FRC's Stewardship Code, for an Ultimate Owners' Council[5] to ensure that the interests of the ultimate owners of investments (ie. individual pension savers) are adequately represented. We will take a close interest in the composition of the proposed new forum and would encourage the FRC to ensure that it contains a diverse range of voices.

Web-based disclosure

We are aware that the FRC's proposals to allow companies to post Annual Reports on their websites, rather than producing them in print, have attracted considerable interests. We agree with the FRC that greater use could and should be made of web-based disclosure methods to reduce the burden of reporting on businesses while improving accessibility and usability for investors and other stakeholders. We recognise the concerns that have been expressed over the potential impact on small shareholders who may be both less likely to have access to the Internet and more likely to be heavily financially reliant on shares in small number of companies. We are confident that a compromise can be found whereby companies are enabled and encouraged to make online disclosure their primary means of dissemination, but with the right to request a paper copy guaranteed for those who need it.

We would be pleased to meet with you to discuss any of the issues raised in this response.

Yours sincerely,

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Chief Executive, FairPensions

James Thornton
CEO, ClientEarth

[5] See FairPensions' response to the FRC's Consultation on the Draft Stewardship Code, and FairPensions' 2010 Report 'Stewardship in the Spotlight'.