

**Contact Us:**

For in-depth advice on external auditors, please contact Chris Stamp on +44 (0) 7785 265335.

## INTRODUCTION

Are we about to witness an evolution in narrative reporting? All the signs are that Government, regulatory bodies, and companies themselves are pushing back against the ever growing list of expected disclosures in a company's accounts. The length of company reports has increased greatly over the last 10 years increasing from 44 pages in 1996 to 100+ pages by 2010 (*Source: BIS Results of consultation on narrative reporting*). However, whilst the volume of information has increased this has not necessarily increased the clarity or usefulness of the information presented. In fact, many hold the opinion that the length and complexity of company reports has served to obscure important and key disclosures relating to the performance of a company.

"The increasing length and complexity of reports may militate against presentation of a clear, coherent and relevant picture of the business." (*Plan for Growth: HM Treasury BIS March 2011*)

The drive for improvement in corporate reporting is set against the backdrop of company and banking failures and the resulting turmoil in the global economy. This has led to the questioning of how companies have conducted their businesses and the contribution that poor corporate governance and behaviours may have made to the financial crises. A part of this examination has involved the review of corporate governance regimes, how company boards operate and reporting by companies to enable a better assessment of their prospects

This briefing considers how narrative reporting has developed, the recent debate on narrative reporting and difficulties faced by companies in getting the balance in reporting right.

## REGULATORY REQUIREMENTS

The expansion of the narrative part of the Report and Accounts has largely been driven by increasing regulatory requirements. For UK listed companies the requirement and content of the directors' report (including the business review), remuneration report and corporate governance disclosures are governed by:

Companies Act 2006  
Listing Rules  
Disclosure and Transparency Rules  
UK Corporate Governance Code.

This is supplemented by guidance published by regulatory bodies such as:

FRC Guidance on Board Effectiveness  
FRC Guidance on Audit Committees  
FRC Going Concern Guidance  
Turnbull Internal Controls Guidance  
FRRP Annual Reports

## THE DEVELOPMENT OF CORPORATE REPORTING

It wasn't that long ago when a company's report and accounts consisted of a slim volume containing mostly financial data and usually only consulted by shareholders to assess the financial standing of the company. The directors' report was often no more than a page long and the bulk of the document consisted of the accounts. Nowadays, directors are expected to report extensively on all aspects of the company's business. In addition the report and accounts often fulfil a variety of functions such as a promotional tool and information source for a variety of stakeholders not just shareholders. This has arisen due to a number of factors not least as a reaction to recent corporate failures and scandals that have resulted in increased legislation and regulation. Pressure from lobby groups has also helped to increase regulation around reporting - remuneration and corporate social responsibility reporting being a case in point.

**THE FUTURE OF NARRATIVE REPORTING**

A key document in the drive to ensure companies provided qualitative non-financial information was the development of the Operating and Financial Review by the Accounting Standards Board first produced in 1993. The OFR remained voluntary until 2005 but was quickly abandoned by the Government in 2005. However, many companies had already begun applying and using the OFR regulations as a best practice standard. The OFR was essentially replaced by the enhanced business review requirements of the Companies Act 2006 (s417). Pressure groups, charities and NGOs had lobbied hard for the introduction of the business review and its content. For the first time companies were asked to report specifically on how their businesses impacted on the wider community.

It has also become clear that pressure groups are prepared to use legislation to hold companies to account as outlined in the publication "Act Now!: A Campaigner's Guide to the Companies Act" (2007). The pressures applied by stakeholder groups and institutional investors is seen by many as having led to the rise of 'kitchen sink' reporting for fear of receiving adverse publicity.

Alongside increased legislation investor relation protection bodies, large institutional investors and proxy voting services often produce their own corporate reporting standards. These include those produced by the ABI, RREV and PIRC. In the case of corporate social responsibility reporting, in addition to the Companies Act 2006, more extensive reporting has been encouraged by the Global Reporting Initiative and trading indices such as FTSE4Good and the Dow Jones Sustainability Index.

**THE DEBATE**

Against this trend of ever greater disclosure there has been a move amongst regulators and legislators to reduce the burden of reporting whilst hopefully increasing the quality and focus of information.

*Financial Reporting Council (FRC)*

The FRC began a project in 2009 to reduce the complexity in corporate reporting. Its publication 'Louder than Words' was a discussion paper to encourage debate in this area. The report identified 'clutter' as a problem in annual reports as key messages were being lost. It was noted that 'generally, if regulations require a disclosure, it goes in the report – regardless of the materiality or importance to the business'.

In its publication "Effective Company Stewardship – Enhancing Corporate Reporting and Audit" (January 2011), the FRC emphasises the importance of increasing transparency in the way that directors report on their activities to embed some of the lessons learned from the recent financial crisis. The FRC sets out its aim to see:

- Higher quality narrative reporting, particularly on business strategy and risk management;
- Recognition of the importance of Audit Committees and their contribution to the integrity of financial reporting;
- Greater transparency on the way that Audit Committees discharge their responsibilities in relation to the Annual Report, including oversight of the external auditors;
- More information about the audit process;
- More accessible Annual Reports through the use of technology.

It is interesting to note that in this document the FRC is asking for greater disclosures on Audit Committees and the audit process. Another of the key recommendations of this report is that directors should take full responsibility for ensuring that the annual report and accounts, viewed as a whole, provide a fair and balanced report on their stewardship of the business.

The FRC has also followed up on the themes of earlier FRC documents with a further discussion paper called "Cutting the Clutter" published in April 2011. It cites the main reason for 'kitchen sink' reporting as behavioural. This is not just of preparers but of regulators, standard setters (including the FRC) and auditors. For example, the existence of illustrative accounts provided by auditors can induce a box-ticking approach regardless of materiality of the disclosure. Including information to err on the side of caution or due to the fear of adverse publicity are given as common reasons for a blanket approach to disclosures amongst those preparing accounts.

## THE FUTURE OF NARRATIVE REPORTING

The Cutting the Clutter report sets out three recommendations. These are:

1. Calls for action to reduce barriers by:
  - Encouraging debate around what materiality means for a disclosure.
  - Investigating how to tackle long-standing explanatory material in annual reports.
  - Engaging with other stakeholders around their information requests.
2. Addressing behaviours within companies, for example by:
  - Agreeing an approach to materiality.
  - Having a single author responsible for a high-level view of the annual report.
  - Having in place plans to 'cut clutter'.
  - Reviewing learning points for preparation of the following years' accounts.
3. Tackling unnecessary disclosures now by reviewing common areas of clutter in annual reports such as:
  - CSR reporting. The focus should be on areas which have a significant impact on the company's long term success. Cross references may be provided to where detailed information is available on a website.
  - Directors' report. Other statutory information may be located in an appendix
  - Principal risks. Companies should focus on specific risks to the company rather than including a generic list of risks common to all businesses.

The FRC have asked for responses to their ideas by September 2011 and have stated their intention to continue to work with Government on its proposals to simplify narrative reporting.

### *Financial Reporting Review Panel (FRRP)*

The FRRP, the body responsible for ensuring that companies comply with financial reporting requirements, sets out its criteria for what makes a good annual report in its 2010 Annual Report. Good reports will explain how the company makes money, report on what worries the Board (ie risk) and explain change. Other items cited to make a good report are to ensure clear, consistent and uncluttered reports with the overall aim to present accounts which are true and fair.

The 2010 Annual Report also highlighted the importance of reporting on a company's business model as this provides a context for reporting on risks, KPIs and accounting policies. It is noted that it is now a requirement of the UK Corporate Governance Code for companies to explain their business model and the FRRP has indicated that it will be looking at business model disclosures in company accounts going forward.

### *Department for Business, Innovation and Skills (BIS)*

In August 2010, a consultation on the future of narrative reporting was set in train by the Department for Business, Innovation and Skills. The three objectives stated in the BIS consultation document were to:

- Drive up the quality of narrative reporting to the level of the best, including on social and environmental issues;
- Empower shareholders so they can act as effective owners;
- Achieve coherence without increasing the regulatory burden on business.

In addition the consultation document cited the coalition's commitment to reinstating the Operating and Financial Review.

The responses to the consultation were published in December 2010 and the Government has built its conclusions into the recently published report 'Plan for Growth'. In this document the Government states its intention to "...simplify the reporting framework to enable quoted companies to provide clear and relevant information to investors about strategy, performance and risk in a simpler and more concise report, with supporting information provided on

**THE FUTURE OF NARRATIVE REPORTING**

the company's website". The Government is clearly prepared to legislate to achieve this aim. Interestingly, in this document there is no mention of reinstating the Operating and Financial Review as part of its aims.

**ACHIEVING THE BALANCE**

The key theme across all the recent discussion papers and consultation documents is that of improving quality and reducing quantity. However, there is clearly a tension between providing concise and focused reports and providing all the information expected by stakeholder groups, auditors and regulatory bodies. The three objectives set out in the BIS Consultation on Narrative Reporting – to drive up the quality of narrative reporting including on social and environmental issues, empower shareholders and achieving coherence without increasing the regulatory burden – encapsulates the conflict facing preparers of the annual report. Reporting on social and environmental issues in particular has been targeted by the FRC as producing "significant immaterial clutter". In the FRC's report 'Rising to the Challenge' (October 2009) it was acknowledged that social pressure had a large part to play in companies feeling obliged to include often irrelevant CSR disclosures. Of the sample provided in the FRC's report only 20% of companies gave convincing reasons why CSR was important to their business.

A further illustration of the difficulties preparers of annual reports face is the recent FRRP review of the 2008 and 2009 Annual Reports of Rio Tinto plc following a complaint. As a result of the review Rio Tinto agreed to provide in its report and accounts for the year ended 31 December 2010 more information about environmental matters, social and community issues and related reputational risks. This was despite the fact that the FRRP acknowledged that the additional information did not materially add to or alter information already in the public domain. However, the position of the FRRP was that the business review should be balanced and comprehensive. The additional information provided by Rio Tinto included potential health risks posed by exposure to workers and communities and the potential for the group's projects to impact on biodiversity. The key issue here to note is that the FRRP expected there to be a balance between the good and bad news stories on the environment provided by Rio Tinto.

**STILL TO COME**

While the voices for streamlining and reducing disclosures in annual reports grows, concern about tackling environmental challenges has increased which may lead to additional reporting requirements for companies. The role of companies in managing their environmental impact is seen as critical and many believe that making reporting on greenhouse emissions mandatory as having an important part to play in reducing emissions. The Department for Environment, Food and Rural Affairs, in partnership with the Department for Energy and Climate Change, has published guidance for companies on how to measure and report on greenhouse emissions and set targets to reduce them. In addition, under the Climate Change Act 2008, the Government is committed either to introduce regulations to require corporate greenhouse gas reporting, or to explain why not. The view of the Accounting Standards Board is that "...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 lengthy annual report."

The European Commission has published a green paper, 'The EU Corporate Governance Framework', asking for comments and suggestions on how corporate governance within the EU may be improved. Many of the issues discussed are already covered by the UK Corporate Governance Code. Other suggestions raised include whether the posts that non-executive directors hold should be limited in number, whether 'independent experts' should review related-party transactions above a certain threshold and whether companies of different sizes should follow different governance regimes. Comments on the paper are due to be submitted by 22 July 2011.

**PRISM PERSPECTIVE**

Regardless of when new regulation will come into effect companies can take steps now to enhance the quality of their reporting. It is worth taking a fresh look at the purpose behind much of the narrative reporting in the report and accounts. Under section 417 of the Companies Act 2006 Directors' reports must contain a business review the purpose of which is to "inform members of the company and help them assess how the directors have performed their duty under section 172 (duty to promote the success of the company)." Companies need to stand back and re-appraise those areas of real importance to their business focusing on performance and risk as key to explaining how directors have promoted the success of the company.

**THE FUTURE OF NARRATIVE REPORTING**

This view is supported by regulatory bodies and legislators and regulatory bodies who are encouraging companies to:

- Consider the primary purpose for reporting in the annual report;
- Simplify and consider disclosures that are material to the company;
- Provide information that may be required by other stakeholders, where regulations permit, in other formats such as on the company website;
- Focus reporting on strategy, performance and risk.

We will watch with interest as to whether the promised legislation will indeed bring a radical change to narrative reporting, perhaps allowing reporting on a principles basis and greater freedom in how and what companies report depending on what is important to their business.

Given that much of the current content of narrative reporting has been driven by external pressure groups it remains to be seen whether companies will still feel obliged to provide catch all reports, regardless of any new legislation in order to satisfy the expectations of pressure groups and investor relation bodies. There will certainly need to be engagement with and education of these groups to reassure them that the information they require will still be available albeit perhaps in a different format.

**SOURCES**

*Act Now!: A Campaigner's Guide to the Companies Act: CORE 2007*

*Louder than Words: FRC 2009*

*Rising to the Challenge: FRC October 2009*

*FRRP 2010 Annual Report*

*Results of the consultation on narrative reporting: BIS December 2010*

*EU Corporate Governance Framework: European Commission green paper 2010*

*Effective Company Stewardship: FRC January 2011*

*Cutting the Clutter: FRC April 2011*

*Plan for Growth: HM Treasury BIS April 2011*

**Prism Cosec  
May 2011**