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Jane Leavens
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Dear Jane,

Consultation response to BIS: The future of narrative reporting

Hermes is one of the largest pension fund managers in the City of London and is owned by the UK's largest pension fund, the BT Pension Scheme. As Hermes' governance and responsible investment overlay arm, Hermes Equity Ownership Services (HEOS) responds to consultations such as this one on behalf of many clients, including the BT Pension Scheme, the Environment Agency, the Lothian Pension Fund, all of the UK, Australia's VicSuper, Canada's Public Sector Pension Investment Board, the National Pension Reserve Fund of Ireland, PNO Media Stichting Pensioenfonds of the Netherlands (only those clients which have expressly given their support to this response are listed here).

HEOS welcomes this consultation on the future of narrative reporting. In our view, the narrative content of a company's annual report represents a great opportunity for it to communicate to investors what is unique about the company. Too many fail to take advantage of this opportunity. Instead, narrative reporting has become the antithesis of good communication. It is usually dry and uninteresting and provides the reader with little real insight into how the company is run. Often, reports lack cohesiveness. To put this another way, there is no guiding hand or continuous thread holding together the various elements of the report. One has the impression that each section is written by a different individual, but no one takes the time to read the document as a whole and ensure it tells a coherent story.

The fact that there are a small number of UK companies producing extremely high quality reports, however, suggests to us that the constraints to doing so are more behavioural and perceived than real, regulatory barriers. We do not

believe that there is anything in the regulation as it stands that prevents boards taking a decision to produce more relevant and readable reports. Indeed, the safe harbour regulations constitute a regulatory lack of constraint on disclosure. Unless the safe harbour is used as was intended, that is to enable directors to more freely make forward-looking statements without fear of legal liability then we increasingly believe it should be removed.

To encourage more to follow the example of the few outstanding examples in this area, Hermes EOS last year established the ICSA Hermes Transparency in governance awards, alongside the Institute of Chartered Secretaries and Administrators (ICSA). These awards recognise high quality reporting in areas such as strategy, risk, board and remuneration. We believe that this initiative should have a significant positive impact.

We would urge the BIS to seek to improve reporting standards through acknowledging high standards or censuring poor disclosure, rather than seeking a legislative response. In particular, we would not wish to see the reintroduction of more stringent reporting requirements in this area as we fear these would only drive adherence to the letter of the law. Rather than seeking to compel companies to report within a predetermined framework, directors need to be empowered and encouraged to deliver to company owners the reporting that they expect and deserve.

Please find below our answers to the specific questions in the consultation. I would be delighted to discuss these with you in more detail.

Yours sincerely,

Jennifer Walmsley
Director

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

i) forward-looking strategy and
ii) principal risks and uncertainties?

While we at Hermes EOS feel that there have been some improvements in the quality of narrative reporting since the introduction of the business review requirements, these have tended to be more form than substance. On the whole, the standard of company reporting at the companies in which our clients invest still leaves a great deal to be desired. The vast majority of annual reports are compiled in legalistic, compliance-led language with boilerplate-style reporting which gives the reader very little insight into how strategy is formulated. Boards seem particularly reluctant to include any forward-looking information; it is almost as if use of the future tense has been outlawed in annual reports. Discussions of strategy tend to be couched in vague, unhelpful terms and be backward-looking.

Reporting of principal risks and uncertainties is somewhat more comprehensive but here, we sometimes find ourselves wishing that boards would be rather less fulsome. There is a great tendency to "kitchen sink" risk reporting and include every risk that could possibly have a bearing on the company with no sense of priority. This makes it extremely difficult for investors to determine the significant risks faced by the company and which are the less significant. We would much prefer to see a shorter, more thoughtful report describing the risk appetite of the company, how this is factored into the strategic discussions and a list of risks arising out of the company's specific strategy and operations rather than a much fuller generic list. We also want to know about the steps the company is taking to manage these but often read only incredibly bland information in this regard. Risk management should be a dynamic process and to this end we would also find it helpful to understand more about the risk identification process and its frequency. To aid our analysis, some sense of which risks are regarded as more or less important each year would be helpful to reflect changes in the environment or risk mitigation programme and to demonstrate that risk management is a living process. We rarely find risk reports that include comprehensive information of this kind.

Directors' failure to show additional discrimination and intelligence in the disclosures that they make raises concerns in our minds about the overall quality of focus and debate within the boardroom. Directors who wish to give investors a positive impression as to their quality would be well advised to ensure that their companies produce reporting which evidences the intelligence within the boardroom, not a tendency to be beholden to constraining legal advice.

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

To our knowledge, there are no regulatory constraints on companies providing more relevant information on these issues. In fact, there is a regulatory lack of constraint in the shape of the safe harbour requirements. This safe harbour was agreed by investors in the expectation that it would lead to higher quality disclosure which was less constrained by legal advice that directors should not make forward-looking disclosures for fear of opening themselves to liability. Given the quality of reporting and disclosure so far evidenced in business reviews and directors' reports more generally we are not at all convinced that this safe harbour is serving its purpose. Hermes EOS is increasingly of the view that unless the protection provided by the safe harbour does in fact lead to less constrained and better reporting it should be removed. We would welcome the corporate community considering what approach they would prefer, but a safe harbour which does not lead to more forward-looking communication does not seem to us to serve an effective purpose.

In our view it should be perfectly possible for boards to disclose the fundamental strategic issues for their business and the major risks it faces without going further and disclosing detailed information which might be commercially damaging. As shareholders, we clearly do not want boards to harm their company's interests with excessive disclosure. So boards should not feel obliged to disclose, for example, the exact percentage of the company's dependence on a key supplier or customer as part of their strategy section. But we do find it unhelpful that, for example, major retailers often talk about strategy as if their competitors do not exist, neglecting to mention market share data that is publicly known and outlining how this is factored into strategy setting.

We believe that there is currently a lack of will on the part of boards to break the mould and go beyond what other companies are providing. We have heard from some companies that the fear of being held to account prevents them from making more fulsome disclosures about potential future strategies. We would counter, however, that investors are sufficiently intelligent to be able to distinguish between fully-fledged strategic decisions and discussions of future ways forward. And any confident management team should be able to explain to investors face to face and in subsequent annual reports why some contemplated strategies were pursued while others were not.

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

It is difficult to imagine how companies could manage to take important strategic decisions if board discussions were conducted in terms as vague and non-committal as the vast majority of annual reports are written. We therefore conclude that most annual reports are not an accurate reflection of the issues discussed by directors in board meetings. Our view is that the

narrative section of the annual report should be a living document which reflects the content of discussions at board-level and between companies and their shareholders over the course of the year. That does not mean that every detail seen by the board must be shared in the annual report; far from it. But if an issue is important enough to fall to the board for consideration, it is likely to merit some reference. Similarly, if a matter does not fall to the board for consideration and decision, it is unlikely to merit inclusion. Shareholders should not seek to micromanage the companies in which they invest and so should not seek disclosure of information which is at the micro level of those companies. In our view, however, company owners are poorly served by current reports if they expect to find in these guidance as to how their company is being managed and how the board is exercising its oversight duties.

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

As stated above, we have seen improvements in some company reporting. We do feel, however, that while there are some outstanding examples of companies making real strides forward in this area there are very, very many that have yet to engage fully with their shareholders via their written communications. As long-term, interested owners, we look to have board-level discussions about a wide range of issues from strategy, capital structure and governance through to social and environmental risks. We try to fulfil the role of a critical friend to companies and to ask probing and challenging questions. We hope that boards find our input helpful and have been given feedback to that effect by many. It is extremely difficult to be able properly to fulfil our responsibilities as an active owner in the absence of good and full information on which to base our questions, however. Good information at board-level is a prerequisite of good board discussion; good quality information to shareholders is necessary for high quality engagement.

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?

Yes, as an active owner of companies on our clients' behalf, we engage with those companies where we feel that information on strategy and risk is either insufficient or unsatisfactory. In the UK, we feel that we have all of the rights and tools that we need as owners to be able effectively to hold companies to account. We have taken voting action at companies where standards of reporting are low. This is something we consider doing where we feel that other methods, primarily dialogue, have failed. It would be helpful if there was a broad acceptance among boards that shareholders expect disclosures on strategy and risk to be meaningful and company-specific rather than full of boilerplate.

We also feel that awards and other recognition of high quality reporting serve a useful function in encouraging others. Two years ago we launched, together

with the Institute of Chartered Secretaries and Administrators (ICSA), the ICSA Hermes Transparency in Governance Awards to reward excellence in reporting. We feel that this has been an extremely useful exercise in raising awareness of what is possible within the current reporting guidelines.

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)?

As part of its role as a responsible owner on behalf of its clients, Hermes votes at all shareholder meetings of companies in which its clients hold shares and undertakes engagement where it has concerns about any aspect of the way in which a company is being managed. Ahead of voting or meeting with a company, we undertake extensive research looking at all of a company's publicly available information. The vast majority of our research is undertaken internally, however we also subscribe to a number of specialist external providers to inform our view of company performance in different areas, for example the environment. The most valuable source of information, in our view, is the discussion that we have with executives and non-executive directors.

7. Is there scope to reduce or simplify the requirements on which companies report?
8. Is there scope to arrange the information in a more useful way?

Reporting requirements have been subject to significant change in recent years and we do not believe that introducing new requirements, albeit ones designed to simplify corporate reporting, would be welcomed by either companies or their owners. In our view, as discussed above, the impediments to more meaningful corporate reporting do not come in the form of regulatory requirements but in perceptions and attitudes.

Certainly we believe that there is significant scope for companies to arrange their reports in a more user-friendly way. For example some companies still do not include an index in their annual reports. Others go further and not only have a comprehensive index but also colour-code different sections to ease navigation. More important, in our view, is cross-referencing between the various areas of the report so, for example, risks are discussed in the context of strategy and not in a silo.

We would also like to include here a note on length. There is sometimes a misapprehension that when investors ask for better reporting they want more or longer reporting. Nothing could be further from the truth. Our concern is to promote quality and usability. The consultation suggests that the narrative report could be limited to a summary of the strategic issues with more detailed supporting information presented separately. Hermes EOS believes that even the largest companies should be able to describe their strategy comprehensively but succinctly within the narrative section of their annual

report. By succinct we mean within 20 pages or so. There should not be a need for a section this length to be summarised. If a board is not able to do this then perhaps there are valid questions to be asked about the coherence of that strategy.

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?

We are comfortable with the provisions of the business review and do not see any advantage to reintroducing elements of the OFR.

Hermes has long been a proponent of a light-touch approach to regulation in this area. We therefore do not believe that a statutory reporting standard would help to improve the quality of reporting. In fact, our view is that the opposite is true. If there is a statutory obligation to report in a specific way then companies will tend, in our experience to comply with the letter of that obligation rather than the spirit. In our view, the most valuable types of reporting capture and elucidate the unique nature of that company. Any attempt to introduce prescriptive reporting requirements, whether by regulation or by practice, runs the risk of driving companies towards formulaic disclosures, defensive reporting and reporting to prescribed standards rather than reporting what is important.

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

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?

As we have stated above in the answer to question 1, we believe that the quality of company reporting could be significantly improved. This view extends to the business review as a key part of the annual report. This information, were it to be provided in a thoughtful, meaningful way would be extremely useful to us as a representative of long-term investors. We use the information that companies provide in their annual reports, among other information sources as discussed previously, to enable us take a view on

behalf of our clients as to those companies' strategy and prospects. The quality of reporting also serves, in our view, as a proxy for quality of management.

Disclosure could be substantially improved not by the introduction of new requirements but, as we have stated in our answers to questions 7 and 8, by a change in attitude and perceptions.

EOS does not believe that there are key issues which are missing across all companies. We do feel, however, that there are likely to be specific issues missing at specific companies. Business Reviews are most likely to achieve their overarching aim if they are written genuinely to reflect the unique attributes of each company. This will avoid the boilerplate which is rightly seen by boards as a waste of their time and similarly seen by shareholders as worthless. It is best controlled by market-based mechanisms whereby disclosure can be developed over time through discussion between boards and long-term shareholders, rather than by detailed legislation or formulaic rules.

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

As is suggested by our answer above, we would not welcome more detailed guidance on how to complete the business review. Each company is unique and it is precisely the business review's capacity to capture this uniqueness which will add value for writers and users of these documents. We would therefore strongly oppose any development of prescriptive reporting requirements, whether these are introduced by regulation or by practice. The business review should not be allowed to become a box-ticking exercise, because this will add no value and be a waste of writers' and users' time. The pursuit of spurious comparability therefore should not drive us towards prescription.

It is vital that directors when they are writing the business review do not feel so constrained by detailed guidance and the regulatory and enforcement framework that they seek legal and other professional advice which will necessarily limit the bespoke nature of the document. We would prefer directors to feel able themselves to draft business reviews without a detailed prescriptive list of rules to follow, and we would prefer that owners themselves should be left to monitor and oversee the quality of reporting.

Even identifying KPIs that are appropriate for all the varied companies within an individual sector is impossible, let alone KPIs appropriate across the whole universe of companies. In our view it is for the directors of a company to determine the types of and the appropriate number of KPIs to include. These must vary from firm to firm in order for the directors to be able to fulfil their obligations under the regulations.

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

While the introduction of a vote on the business review might appear to be a helpful way to increase the accountability of companies to their owners, we are not sure that this is the best way forward. Engaged, long-term owners will wish to communicate with companies about the content and quality of their business review. We believe that seeking a vote on such specific matters implies a failure of stewardship where investors are only willing to communicate with companies in such a formal, blunt basis. We believe that the legal and regulatory framework should facilitate nuanced and intelligent dialogue between companies and their shareholders - such as we believe is intended by the Stewardship Code - rather than the poor articulation of views implied in a resolution.

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

In EOS' view there are multiple private organisations that provide data and assistance to companies wishing to improve the quality of their reporting. Consultants and others frequently publish best practice examples in publicly available reports.

Hermes has for the past two years worked closely with ICSA on a set of awards that reward transparency in reporting on a range of areas including strategy, risk, remuneration and governance more broadly. In the longer term, we believe that this initiative, along with others mentioned above, should help to raise awareness for companies of what is possible. We also believe that the call for greater engagement by shareholders will lead to more investors requesting better information of companies.

As well as congratulating the best companies by this means we are also in the process of collecting examples of the worst and are considering how we might best use this information for the purposes of encouraging improvements.

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

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

The clarity and comprehensiveness of remuneration reports varies enormously, as with other aspects of company reporting. As a general comment, while there is often a great deal of information contained within remuneration reports about amounts paid and financial performance criteria this is not always presented in an easily digestible way. Nor is it common to find clear explanations of how performance criteria relate to strategic

objectives and risk management. The vast majority of companies in the FTSE All-share, for example, use earnings per share or total shareholder return or a combination of these as performance targets for their long-term incentive schemes. It is difficult for us to believe that these types of hurdles are appropriate in all cases. There is also often a marked disconnect between company performance and pay-outs to executives under short and long-term schemes. We have seen over the last year examples of companies that have performed poorly and made substantial redundancies and yet executives have continued to receive bonuses. As long-term owners of these companies, we need more convincing that such payments are merited.

Information on the process by which remuneration structures and outcomes are decided is extremely rare.

As will be clear by now, we are not keen on the introduction of new disclosure requirements to remedy the shortfalls that we perceive in company reporting. We would therefore state, once again, that we believe improvements need to come through a combination of greater awareness of best practice in this area and a willingness on the part of remuneration committees and boards to break the mould. There is nothing in the current requirements, to our knowledge, that prevents more fulsome integrated reporting in this area. Indeed the new UK Corporate Governance Code is unequivocal in its encouragement to companies to say something meaningful in their reporting in particular in narrative sections such as the chairman's statement and committee reports. We welcome and echo this exhortation.

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.

As an investor rather than a report preparer, we do not have any insights on the costs of current or future potential reporting requirements. We would reiterate our view that narrative sections of annual reports need not run to many, many pages. Indeed we would much prefer that they did not.

A company's annual report is an opportunity for it to communicate openly and directly with shareholders, and thereby to win additional investment and lower their cost of capital. It should not, in our view, be seen as a cost burden, particularly if companies seize it as an opportunity to set out their stall for current and prospective shareholders rather than feeling obliged to comply with rigid guidelines.