BIS | Department for Business Innovation & Skills

Consultation response form: The Future of Narrative Reporting

A copy of the consultation available at: ://www.bis.gov.uk/ .

Responses to the Consultation by be received by 19 October 2010

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Please tick the box from the following list of options that best describes you:

	Quoted company
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NB. Our consultation response is supplemented by annexes, found at the end of this document. These provide detail and evidence to statements and proposals made in our response.

ClientEarth

Introduction

The regulatory approach

1. Improved narrative reporting is part of a broader government policy push in corporate governance, geared towards the empowerment and encouragement of shareholders to drive and regulate corporate practice, acting as effective corporate owners. If shareholders are to play this role then information, and indeed the right kind and quality of information, is an indispensable tool. This tool must be provided.

2. Mr Edward Davey, minister for Corporate Governance, recently stated in a speech to the Association of British Insurers:

> *"...open and honest relationships between directors and shareholders, where investors are willing to speak up when they think the strategy is wrong* [are the bedrock of effective corporate governance]*. The activism that has marked the recent AGM season is a welcome sign.*
>
> *Shareholders need to rise to the challenge of effective stewardship - and their activism needs to be well-informed so it helps shape the right longterm strategy for the business...*
>
> *That's why shareholder empowerment is an important principle underpinning the Government's work. And why it's a key feature in our consultation on narrative reporting.*
>
> *Companies need to empower shareholders – big and small – by providing the information they need to act as effective stewards."* [1]

3. This policy drive to increase the integrity and sustainability of corporate governance is in considerable part a response to the major failures of corporate governance that characterised the second half of the last decade, and have had such major implications for the UK's economy. As Mr Davey commented in the same speech:

> *"These issues – promoting strong boards and engaged shareholders – are particularly important when considered in the context of the financial crisis. After all, the failings of the financial institutions, their management and owners, were an important factor in bringing about the crisis."* [2]

4. Strong corporate governance is the bedrock of a stable and sustainable economy. The integrity of corporate governance is fundamental to creating a model for UK business and a financial system that can recognise and address risk.

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[1] Edward Davey - ABI Investment Conference 2010 Speech (15 September 2010) at <http://nds.coi.gov.uk/content/Detail.aspx?NewsAreaID=2&ReleaseID=415487>

[2] *Ibid*.

5. A key question follows: what does the company report that allows shareholders to act as effective stewards look like? What types of information must it contain, and what characteristics must that information have? Can that company report, with information of those types and characteristics, be *ensured* by a non-regulatory approach?

6. Reliable and verified information on the right issues, which is accurate, balanced and comprehensive – identifying and illustrating success *and* failure, opportunity *and* risk – is the essential foundation of prudent, informed and well-directed shareholder activity and governance. In our view, information of this character can only be achieved by a robust and effective regulatory framework.

7. The government has stated that it does not intend to increase the regulatory burden on companies, as the coalition government is *"not in the business of weighing companies and investors down with more regulation and higher costs"*.[3] This broad policy spirit has found expression in the government's 'one-in-one-out' regulatory policy, and the third stated objective of the narrative reporting reform process: *"to achieve coherence without increasing the regulatory burden on business"*.[4]

8. In our view, too rigid an approach to regulatory burden has the potential to fatally undermine the project of shareholder empowerment, the development of effective corporate governance in the UK, and the government's broader efforts to address economic short-termism and risk in financial systems. The government risks placing a burden and responsibility on shareholders that they essentially do not have the prospect of carrying.

9. We consider reform of company reporting regulation to be a key part of the broader programme of government that seeks to address systemic financial risks. As such, in our view it should not be considered within the 'One-in, One-out' framework.[5]

10. The government has an opportunity at this juncture to set in place a coherent, clear and effective legal framework that can provide the foundation for a higher standard of corporate governance in UK companies, which in turn will provide a stable and reliable foundation for the UK economy. We urge that it does so.

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[3] Edward Davey - ABI Investment Conference 2010 Speech (15 September 2010)

[4] Department for Business Innovation and Skills, 'The future of narrative reporting – a consultation' (August 2010), p. 7

[5] In the BIS press release that announced the one-in-one-out system, note to editor 4 states that "Regulations in response to emergencies and to address systemic financial risks will be excluded from the One-in, One-out system." (Department for Business, Innovation and Skills Press Release, ' New rules to hand over powers to individuals and companies by cutting red tape and bureaucracy' (5 August 2010) at <http://nds.coi.gov.uk/content/Detail.aspx?ReleaseID=414871&NewsAreaID=2>)

<u>Question 1</u>: Are company directors providing useful and relevant information on the company's:

i) forward-looking strategy and

ii) principal risks and opportunities?

11. In a survey conducted in summer 2010 by the SAS consultancy, only 28% of investors were found to feel that annual reports clearly articulate the strategy of the business:[6]

> *"Only 28% of investors surveyed feel annual reports clearly articulate the strategy of the business. Investors are demanding a clearer statement of strategy and greater use of KPIs in the measurement of company performance."*[7]

12. In a survey conducted by the Institute of Chartered Accountants of Scotland (ICAS), fielding responses from over 200 professionals across the investment industry,[8] it was summarised that:

> *"A serious discussion of the future risks faced by companies was considered to be an important aspect of management commentary and one that was often lacking in annual reports."*[9]

13. Our detailed analysis of the annual reports of two of the UK's largest company groups has also revealed extremely problematic reporting on strategy, risks and opportunities. The reporting practices of these two groups, Rio Tinto and BP, have been highlighted by cross-cutting studies to be among the best of the FTSE 100 in relation to 'non-financial' matters.[10] Given the issues that we observed in these reports, this is a stark indication of the likely quality and reliability of information in the annual reports of UK companies, and the effectiveness of the current legal framework. For detailed illustration of the points raised below in relation to these company reports, please see Annex 1.

14. Among other things, both analyses highlighted a common problem: a lack of balance and candour in company reporting, and the selective disclosure of information so as to present the company, and its development and performance, in a positive light. BP's annual report 2009 provides a particularly stark illustration of this problem, in which a highly important strategic issue (long-term outlook for the company's market) was addressed with an extreme lack of balance, rendering that information useless and indeed misleading to investors. Please see Annex 1 for details.

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[6] Victoria Wheelwright, 'Finance Week – Corporate reporting: what investors want' (9 July 2010) at <http://www.sasdesign.co.uk/2010/7/9/finance-week---corporate-reporting-what-investors-want.aspx>

[7] *Ibid*.

[8] Fraser I, Pierpoint J, Collins B, Henry W (Institute of Chartered Accountants of Scotland), 'Meeting the needs? User views on external assurance and management commentary' (June 2010) at <http://www.icas.org.uk/site/cms/contentviewarticle.asp?article=6852>. The survey constituted an initial questionnaire to which ICAS received responses from 206 investors and 82 stakeholders (e.g. credit analysts, insolvency practitioners), followed up with 26 detailed interviews with participants from across the breadth of participant groups (fund managers (both general and corporate governance specialists), sell side analysts, buy side analysts, investment industry trade association representative, private shareholders, regulators, community business organisation, trade union representatives, insolvency practitioners etc).

[9] Ibid.

[10] Adrian Henriques (CORE Coalition), 'The reporting of non-financial information in annual reports by the FTSE100' (2010), p. 9 at <http://corporate-responsibility.org/wp/wp-content/uploads/2010/04/Reporting-of-Non-Financial-Information-by-the-FTSE1003.pdf>

15. This problem of 'spin' in company reporting is a widely acknowledged reality, and drastically undermines the quality and value of company reporting. The aforementioned study by ICAS reported that, in terms of factors that have a detrimental effect on the scope and quality of management commentary:

> *"The principal complaint was managerial bullishness of the statements made and the amount of 'spin'."*[11]

16. In our view, only an effective regulatory framework can address this problem. Voluntary solutions cannot adequately incentivise balanced and frank disclosure, even where the news for the company is bad; we consider that only the threat or reality of action in pursuit of legal compliance can achieve this.

17. Our analysis of the Rio Tinto Group's report also highlighted a particular problem with company reporting on strategy and risk: the lack of connection between statements made about the company's top-level strategy (or its identified strategy priorities and risks), and the detailed information provided in reports. Our analysis related to 'sustainability' practices and environmental and social matters (identified by the company as key strategic issues and risks), but we understand the issue to apply equally to other matters of strategy and risk, in the reports of many companies. We have heard this broader complaint voiced by investment professionals and other stakeholders.

18. In company reports we have observed a recurring pattern whereby (1) operating in a sustainable or social and environmentally responsible manner is highlighted as a key strategic priority by a company; and (2) environmental and social issues or impacts are identified as relating to significant risks for the company; but (3) there is an absence of detailed, useful and balanced disclosure of facts or data on those matters.

19. Reporting of this type does not allow shareholders to make an informed judgement about the company's performance or position in relation to those issues or risks, and does not allow assessment of how the company's directors are performing their duty to promote the success of the company.

20. A related observation is that in relation to environmental and social matters, reports often cover policies and processes that the company has in place to address a given matter, but rarely address *outcomes* and *performance* in a useful way. In our view, reports must explain what impact the policies and processes of the company are having on outcomes and provide data that allows assessment of performance. Enron had a weighty 'ethics' manual. Lehman Brothers had a 'Quantitative Risk Management Policy Manual'. BP discussed its policy progress in relation to process safety at length in its 2009 annual report. Many modern multinational companies have long and detailed policies and manuals on how to approach a range of environmental or social issues. This does not mean that they are achieving improved outcomes on those issues – it does not mean that they are performing well, maximising opportunity for long-term value creation and minimising risk of value destruction. Information on policies and processes are useful but outcomes are key.

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[11] Fraser I, Pierpoint J, Collins B, Henry W, 'Meeting the needs? User views on external assurance and management commentary' (June 2010) p. 73 at <http://www.icas.org.uk/site/cms/contentviewarticle.asp?article=6852>

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

The role of the regulator

21. An active and effective regulator is essential to providing incentives for even basic legal compliance in company reporting. It is particularly central to ensuring that companies provide *balanced* information in their reports – 'warts and all', as is not necessarily the intuitive tendency of many institutions or organisations when they are required to describe their performance to those to whom they are accountable. Unless companies know that regulatory intervention and sanction will result from non-compliance and the non-disclosure of negative aspects of their practices and performance, then we do not consider that there be adequate incentive to do so.

22. The current approach of the Financial Reporting Review Panel (FRRP) is concerning in this regard. The FRRP's activity report for 2008/09 states that the FRRP judged the legal compliance of a number of narrative reports in that year to be doubtful.[12] It went on to state that where the FRRP identified a doubt as to legal compliance, *"[t]he Panel did not ask for a substantive response to the matters raised but asked that they be considered when the directors prepare the companies' next financial statements if they were relevant or material to the company's reporting"*.[13] There is nothing in the FRRP's Annual Report 2010 to suggest that it has adopted a different approach to compliance action since. The FRRP's website also states that it has never made an application to court regarding company non-compliance with accounting or reporting requirements.[14]

23. This is far from the robust approach that is necessary to ensure compliance with a legal framework, and to ensure that companies understand that it is not an option to fail to comply with legal requirements.

24. We consider that the quality of company reporting could have been driven up considerably further under existing legislative requirements, had a proactive and robust approach been taken by the FRRP. This is particularly the case in relation to the central business review requirements that reports constitute a fair review of the business, and a balanced and comprehensive analysis of the development, performance and position of the company's business. This is not to say that changes to the legislative and regulatory framework are not necessary (see below, and further in Q10 and Annex 4), but simply to emphasise the importance of implementation.

25. Legal requirements, and their adequate implementation, are one of the only ways in which the incentives can be provided for companies to overcome practical or other barriers to the frank disclosure of necessary information on these issues, whether painful or otherwise – 'warts and all'. It is essential that both law and regulator be fit to task.

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[12] Financial Reporting Review Panel, 'Review Findings and Recommendations - 2009' (2009), p. 4 at <http://www.frc.org.uk/images/uploaded/documents/Annual%20Activity%20Report%202009%20-%20%20FINAL.pdf>

[13] Financial Reporting Review Panel, 'Review Findings and Recommendations - 2009' (2009), p. 4

[14] FRRP website, 'About the Panel' at <http://www.frc.org.uk/frrp/about/>

The need for clear legal standards, a statutory reporting standard, and clear direction on materiality judgements

26. The absence of clarity and detail in the business review requirements, particularly in relation to environmental and social matters, and a lack of clarity as to how companies are required to approach materiality judgements in order to be compliant with the law, are a key constraint on companies providing meaningful and adequate information on these issues.

27. Requirements to report on environmental and social issues were introduced because these issues are recognised as fundamental to companies' long-term value generation.[15] The need for company reports to adequately allow an assessment of how directors have considered and managed environmental and social issues is also central to the government's manifesto commitment to reinstate the OFR. In our view, reporting on these key long-term issues for business has been impeded by the absence of detail in legal requirements, and the absence of detailed guidance to directors as to what issues must be reported, and how materiality judgements are to be made in relation to them.

28. Please see our comments in Q10, and Annex 4, for detailed discussion of the steps that we consider necessary to provide clear legal requirements, a statutory reporting standard covering the necessary issues, and guidance to directors on how to establish the processes necessary to prepare an OFR and achieve legal compliance.

[15] These reporting requirements were introduced as part of the legislative package to place 'enlightened shareholder value' at the heart of company law. The legislative purpose of the business review is to inform members of the company and help them assess how the directors have performed their duty to promote the success of the company, including their duty to have regard to the impact of the company's operations on the community and the environment (Companies Act 2006 s172). The Department of Trade and Industry's introduction to the Ministerial statements relating to directors' duties under the Companies Act 2006 stated that "There was a time when business success in the interests of shareholders was thought to be in conflict with society's aspirations for people who work in the company or in supply chain companies, for the long-term well-being of the community and for the protection of the environment. The law is now based on a new approach. Pursuing the interests of shareholders and embracing wider responsibilities are complementary purposes, not contradictory ones... The new expression of the duties is part of the wider recognition and encouragement of change in the Act. The enhanced business review, which for quoted companies must now include information on environmental, employee, social and community issues, is another key example that builds on the growing consensus that it is good business sense for companies to embrace wider social responsibilities." (Department of Trade and Industry, 'Companies Act 2006, Duties of company directors: Ministerial statements' (June 2007) at <http://www.berr.gov.uk/files/file40139.pdf>).

<u>Question 3:</u> Does the information provided reflect the issues discussed by the directors in board meetings?

29. We have no comment as to whether the information provided in company reports reflects the discussions had in company board meetings through the year.

30. We agree that reports should provide a reflection of how the directors have managed the business of the company during the past year, and should contain frank discussion of the issues that were within the scope of board discussions through the year.

31. However, in our view the reporting process can and should also *drive* management practice, rather than simply serving to reflect it. A major policy goal of the Companies Act 2006 was to cultivate a long-term mindset in business. A major stated goal of this government is to tackle economic short-termism. The reporting process is a point for reflection by management, and the right regulatory framework can push directors to consider issues associated with their business that they have not necessarily done so through the year, but which will have bearing on the long-term success of the business.

32. Under the previous OFR framework, guidance was developed and published to help directors to establish the processes necessary to write their OFRs, to make materiality judgements, and to comply with the law.[16] The guidance was developed by an esteemed multi-stakeholder working group[17] and following extensive consultation. That guidance placed strong emphasis on the need for directors to look well beyond their board agendas from the past year in considering what is to be included in company reports. It also emphasised the role of company reporting in driving improved strategic decision-making and practice. Please see Annex 2 for relevant excerpts.

33. In our view, this is the approach that should be adopted when developing a new reporting framework. The reporting process should stretch directors and companies to consider matters that they may not have previously considered, and to assess their significance to the long-term success of the business, taking the nuanced view of success – 'enlightened shareholder value' – that was intended by the Companies Act 2006, and that remains the priority of the current government.

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[16] Department of Trade and Industry, 'The Operating and Financial Review: Practical Guidance for Directors' (May 2004) p. 11 at <http://webarchive.nationalarchives.gov.uk/tna/+/http://www.dti.gov.uk/cld/pdfs/ofr_guide.pdf/>

[17] Rosemary Radcliffe CBE, Economist and member of the Company Law Review Steering Group; Gerry Acher CBE LVO, Chairman, Company Reporting Working Party, Advisory Committee for Business and the Environment; Deborah Doane, Chair, Corporate Responsibility Coalition; Mark Goyder, Director, Tomorrow's Company; Phil Hodkinson, Chief Executive, Insurance & Investment Division, HBOS Plc; Mary Keegan, Chairman, Accounting Standards Board; Rob Lake, Head of SRI Engagement and Corporate Governance, Henderson Global Investors; Graham Ward, Senior Partner, Global Energies & Utilities Group, PricewaterhouseCoopers and Deputy President of The International Federation of Accountants.

<u>Question 4:</u> Does the information help shareholders to press directors on key issues relating to strategy and risk, or inform their business decisions?

i. Informing business decisions

34. We do not believe the quality of information currently found in company annual reports on many issues that relate to strategy and risk to be adequate to inform the business decisions of shareholders. This is particularly the case in relation to environmental or social issues. We cannot see how it could be confidently relied upon for these purposes.

35. This is a view apparently shared by others seeking reliable information on risk, particularly as relating to environmental and social matters. RepRisk is a *'leading provider of dynamic data on environmental and social risks for...companies and projects'* [18], whose clients include Credit Suisse, Deutsche Bank, Goldman Sachs, J.P.Morgan and UBS, among others.[19] Karen Reiner, senior analyst at RepRisk, recently wrote (with reference to the BP Deepwater Horizon disaster) that:

> *"with hindsight most people agree that for investment decision-making purposes investment managers cannot only rely on the information provided by the company itself, but rather should primarily use independent assessments of the company's associated ESG risks...*
>
> *...we believe that an essential part of ESG risk analysis is screening third-party sources such as print media, NGO websites, newsletters, news sites, governmental agencies, etc. to assess the environmental and social performance of a company based on its activities in the field."*

36. This is a reflection of the quality of information currently provided by company annual reports on key business risks associated with environmental and social matters.

Reliability: third party scrutiny and verification

37. First, we perceive a problem in the reliability of the information in company annual reports. The information in narrative reports is not currently meaningfully scrutinised or verified by an independent third party:

- The mandatory audit under the Companies Act 2006 does not allow for meaningful review or verification of company reports, requiring only a broad consistency check with the accompanying accounts. This can catch only the most flagrant and egregious misstatements or exaggerations.

- The FRRP is not adopting an approach to compliance that can allow the information in company reports to be trusted. As highlighted under Q2, even where the FRRP considers a report to be non-compliant with the law, they will currently only go so far as to highlight their concern and request that the company considers that concern in

[18] RepRisk website, Homepage at <http://www.reprisk.com/>
[19] RepRisk website, 'Clients' at <http://www.reprisk.com/repriskclients/>

the next reporting cycle. It is hard to see how a shareholder is to rely on the information in company reports in this context.

38. Without independent scrutiny and verification we do not consider that reports can be trusted for accuracy and relied upon with confidence in investment decision-making.

Balance and detail

39. Second, in a number of company reports we have observed a lack of detailed information on performance and outcomes, in relation to matters identified as key strategic issues or risks. Again, this is particularly the case as regards information relating to environmental and social matters. Company reports will include headline 'boilerplate' descriptions of risks, but balanced detail will not be provided in the report to allow shareholders to assess how those risks are being managed, or how they are manifesting themselves. Please see Q1 and Annex 1 for illustration in relation to the Rio Tinto Group's Annual Report 2008. It is difficult to understand how business decisions can adequately be made without information on performance, as opposed to only processes or policies.

40. Company reports are rarely if ever self-critical, other than where a problem has manifested itself publicly or in the company accounts, in a way that cannot possibly be ignored. Even in these circumstances the degree of candour with which reports will address the matter is to be questioned. In our view, this situation could be significantly improved by an active regulator, willing to intervene where this is the case. Unless company reports provide a balanced picture of a given issue, with due emphasis on both the negative and positive, we do not see that shareholders and investors can confidently rely on the information for the purposes of decision-making.

ii. Allowing shareholders to press directors on key issues

41. Detailed information is the foundation of effective engagement. If adequate information is not provided in company reports, shareholders are forced to expend their limited time and resources seeking adequate disclosure, before a conversation can be had about the judgements of directors on key issues. For example, it required the lodging of a shareholder resolution at the AGMs of BP and Shell for those companies to disclose the carbon price that they are basing long-term strategy on. Without even such basic information on such a key long-term issue for an energy company, can shareholders effectively press directors on strategy relating to those issues?

42. Further, shareholders and investors cannot be expected to be in a position to 'know what they do not know'. If a regulatory framework does not ensure candid, balanced, comprehensive and accurate reporting on issues such as this, it cannot be expected that shareholders and investors will necessarily be expertly placed to look behind the reporting, recognise what they are not being told, and challenge the company's strategy on that issue.

<u>Question 5:</u> 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?

43. We have challenged company reports where we consider that sufficient or material information on environmental or social matters has not been included, by making a referral to the Financial Reporting Review Panel. The outcome of this process remains to be seen. We intend to continue to challenge companies on their reporting of these issues, where we consider that the treatment of environmental and social matters is not compliant with legal requirements.

Shareholder challenges

44. As discussed in their consultation response, FairPensions were another civil society group involved in challenges made to BP and Shell by shareholders regarding inadequate disclosure, made through the shareholder resolution process. Their experiences suggested that it is an imperfect and costly mechanism. They found the procedures for filing shareholder resolutions onerous and complex.

45. We have also heard investment professionals remark in strong terms that the rules relating to the cost of circulating shareholder resolutions and shareholder statements create a major deterrent to the use of those tools to challenge disclosure by companies (or their use for any other purpose). Currently shareholders cannot be sure that they will avoid the costs of circulation unless they lodge the request before the end of the financial year.[20] This means that if shareholders wish to be sure of avoiding major costs, they must lodge their request and statement before the annual reports are published: leaving them guessing as to whether the issue they seek to raise will be addressed in the company reports, and without the prospect of the resolution being used in response to inadequate disclosure in annual reports. We recently heard a representative of a global asset management firm remark that the costs of circulation were viewed as material, even for a large firm such as his.[21]

46. It is also notable that in the UK, as compared with other jurisdictions such as the United States, there is a cultural reluctance to utilise these tools of engagement, for apparent fear to be seen to be 'going against' management. We understand shareholder resolutions to be viewed by many shareholders and fund managers as a 'nuclear option', or the territory of 'activists'. This cultural tendency is problematic, particularly if the propensity of shareholders to challenge companies on inadequate disclosure is being relied upon by government as a robust alternative to a regulatory framework that can ensure adequate disclosure in the first place.

47. This also runs to the question of openness, and where these conversations on company strategy, practice and performance should be taking place. These conversations should not be left to private briefings and individual engagement. In that circumstance, major investment houses benefit from better access, while smaller shareholders are left disadvantaged. This acts against the interests of high quality corporate governance.

[20] Companies Act 2006 s 340
[21] 'The Future of Narrative Reporting Workshop' hosted by BIS, 27 September 2010.

Enabling shareholder challenge and engagement

48. In the context of the above, the introduction of an advisory vote on the OFR would be welcome – any mechanisms which encourage shareholders to question whether they have been provided with satisfactory information and to engage with the company on that matter, and particularly where that engagement is public, is welcome. However, in order for such a reform to be meaningful, a collateral shift of culture in shareholding will be necessary, in order to move past a situation where the majority of shareholders simply vote with management without a thought.

49. It is also interesting to note that at a recent roundtable of investment professionals, we observed overwhelming support for an advisory vote on the company's *sustainability* report (more than that for a vote on the OFR). This again appears to be a way in which shareholders could be helped to challenge inadequate company reporting.

50. Additionally, the procedures for filing shareholder resolutions should be reviewed to see whether there is space for greater clarity and simplicity.[22] The rules relating to cost burden should also be re-examined, if the shareholder resolution is to be a realistic option for the challenge of disclosure in OFRs.

The adequacy of the FRRP's current role

51. We also do not consider that it should be necessary for a civil society organisation such as ourselves to play the roles discussed above, and nor do we think that it should be left to shareholders to recognise and challenge omissions in company reporting – shareholders cannot be expected to have expertise or resources that allow them to identify gaps or omissions in company reports (please see Q4). Further, if shareholders have to first identify that there is an omission in company reports, then challenge the company to provide further information, before they can begin substantive engagement with management regarding their approach to that issue, we are unlikely to see the engagement between shareholders and businesses that is the hope and intention of the government.

52. The regulator has and must have the central role in ensuring adequate disclosure by companies. Problems we perceive with the FRRP's current role and practice in this regard:

    - The FRRP does not appear to be adopting the approach and action necessary to ensure the compliance of company reports with legal requirements.
    - The FRRP does not appear to be adequately resourced so as to play a proactive role in ensuring that companies comply with legal requirements for narrative reporting.

53. Further, as regards the role of the FRRP in relation to enabling shareholders and others to challenge the disclosures of companies:

    - The FRRP acts as 'gatekeeper' to enforcement of the law – anyone who wishes to challenge the compliance of company reports must do so via the FRRP, and is therefore reliant on its capacity and inclination to enforce.

[22] We understand that FairPensions have already given comments on their experiences and recommendations to BIS.

- Our experience suggests that the FRRP's enforcement role, and its complaints mechanism, is not widely known among shareholders, investment professionals or civil society.

<u>Question 6:</u> 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)?

54. Information from unregulated company sources cannot be a substitute for information that has been adequately audited and scrutinised. While we do not consider that the information in company reports is currently adequately audited and scrutinised, we hope that it will be following the government's review.

55. If other reporting mediums are being considered as places where some of the information currently swamping annual reports could be re-located (so as to simplify and shorten company annual reports), the question of how that information is regulated and verified must be examined carefully – reliability remains key if this information is going to be relied on for the purposes of decision-making.

Third-party sources

56. In our experience, in order to get a complete and balanced picture of a company's environmental and social practices and impacts, and how those practices and impacts relate to the company's business and financial performance, reference to third party sources and analysis is necessary.

57. In terms of trying to get an accurate and balanced picture of the company's performance as relating to environmental and social issues, we have found company annual reports to be of limited value.

58. This is a view apparently shared by others seeking reliable information on risk, particularly as relating to environmental and social matters (please see Q4 for illustration).

<u>Question 7:</u> Is there scope to reduce or simplify the requirements on which companies report?

59. We strongly oppose any further reduction in the already minimal requirements on which companies report.

60. In our view, the vague and sparing nature of the current requirements on which companies prepare their business reviews is a major obstacle to high quality reporting.

61. We consider that the absence of specific and detailed regulation as relating to reporting has been central to the proliferation of company reports that are lengthy and lacking focus, that omit material information, and that are of little use to shareholders, investors or stakeholders. Certainly as regards reporting on environmental and social matters, we consider the absence of detailed requirements has allowed the proliferation of 'CSR' reporting that is of that nature.

62. Clearly, there is desire among many stakeholders for space to be left for companies to 'tell their own stories'. There is the perceived risk in more detailed regulation that it will strip reports of their individual character, resulting in bland and 'boilerplate' reporting. In our view, there is no reason that mandatory disclosures on specific, prescribed issues or indicators cannot sit alongside a narrative that is the company's own. There is no reason that a well crafted reporting standard on aims, considerations, materiality judgements and other matters will stop directors from telling a story in the OFR that is individual and engaging. A reporting standard could also emphasise that boilerplate and meaningless reporting is not acceptable, as could the regulator in its engagement with companies.

63. There is no reason that space cannot be left for companies to 'tell their own story' in their reports if a more detailed legal and regulatory framework is introduced.

<u>Question 8:</u> Is there scope to arrange the information in a more useful way?

64. Please see Q9 and Annex 4 for our comments in relation to Key Performance Indicators ('KPIs'). We consider the proper contextualisation and explanation of KPIs to be essential to their usefulness in company reporting.

<u>Question 9:</u> 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?

i. The statutory reporting standard

65. We strongly support the introduction of a reporting standard against which narrative reports must be developed, that gives detailed expansion on legislative requirements, and can assist directors in understanding how they are expected and required to report.

66. RS1 provides a good starting point for the development of a new statutory reporting standard. However, in our view RS1 needs to be reassessed in certain regards.

67. Please see Annex 3 for further discussion of the points set out below.

RS1: objective standards

68. Any statutory reporting standard should stress the objective standards of care, skill and diligence required of directors when preparing company reports, and against which the compliance of reports will be judged. Any statutory reporting standard should make it clear that when company reports are being assessed for compliance with legal requirements, that the assessment will be that of what the reasonable director would have considered necessary to satisfy compliance with legal requirements.

69. Further, while we agree that company reports should to an extent reflect the way that the directors view the business, the reporting process should also push management to think beyond their existing view of the business and what is relevant to it (see comments in Q3 above).

RS1: forward-looking orientation; environmental and social matters

70. We strongly support the forward-looking and long-term emphasis of RS1. Under the Companies Act 2006 regime, there is little in law or guidance that adequately conveys the long-term nature of the reporting requirements, and the need for reports to address business success through the prism of 'enlightened shareholder value'.

71. However, we consider that RS1 should have placed greater emphasis on the connection between the obligations on companies to report on environmental and social matters, and the long-term outlook of the OFR. We consider that any statutory reporting standard should explicitly address the ways in which environmental and social matters are to be considered relevant to the business: that they must be considered beyond the short-term context and their quantifiable short-term materiality, looking primarily to the long-term role that such matters play in shaping a company's business and its success.

72. We also consider that a statutory reporting standard should place greater emphasis on the specific environmental and social matters that may need to be discussed in company reports in order for them to achieve compliance with legal requirements.

73. Emphasis should also be placed on the way in which environmental and social issues must

be reported: discussion of the issues in a broad sense and how they relate to the business; the policies the company has in place to manage or address the issues; and information (both good and bad) that allows an informed assessment of the development, performance and position of the company in those regards.

RS1: materiality judgements

74. In our view a new reporting standard should explicitly address the issue of materiality, stressing the way in which the principles and rules of a reporting standard, and the statutory purpose of the business review / OFR, define the way in which companies should be approaching materiality judgements.

75. Many of the principles of RS1 have clear bearing on the way that judgements should be made about whether information should or should not be considered material and included in reports. The statutory purpose of the business review, with its link to the directors' duties to promote the success of the company and enlightened shareholder value, also has major implications for how materiality judgements must be made in order for reports to be compliant with the law. These implications should be set out in any reporting standard.

RS1: joined up reporting between strategy and performance

76. We also consider that any new statutory reporting standard should emphasise the need for company reports to follow through on statements regarding strategic priorities, risks and opportunities with detailed information that allows for an informed assessment of the company's performance specifically in relation to those matters. As discussed under Q1, we consider this to be a problem in current reporting practice. RS1 did not emphasise this matter, and in our view a new statutory reporting standard should do so.

RS1: Key Performance Indicators

77. RS1 included a number of provisions relating to the use of KPIs in company reports. We strongly support the original OFR framework's emphasis on the need for quantitative indicators to be clearly explained and understandable, and to be used consistently across reporting cycles. In our view the provisions of RS1 relating to KPIs should be introduced as legislative requirements. Please see Annex 4 for further discussion.

RS1: evidencing claims

78. We also strongly support the emphasis placed in RS1 on the need for reports to explain and contextualise *any* assertions made or information provided, in terms of the need to discuss the evidence underpinning any claim and the degree to which the assertions or information in company reports are objectively supportable.[23]

ii. The mandatory audit

79. We strongly support the higher standard of mandatory audit that was required under the

[23] Accounting Standards Board Reporting Standard 1: Operating and Financial Review para 20 at <http://www.frc.org.uk/images/uploaded/documents/Web%20optimized%20OFR%20REPORTING%20STANDARD.pdf>

previous OFR framework. We consider the reliability of information in company reports to be of the upmost importance to effective corporate governance. The audit is one of the few ways in which company reports can be scrutinised and verified by *independent* and *impartial* persons with the access to information and explanations from the company necessary for this task to be carried out effectively.

80. The reliability of information in company reports is central to the question of whether the government will succeed in the creation of a robust and effective framework for corporate governance that can recognise and address risk, and that can therefore more broadly act against systemic financial risk.

81. We have heard it suggested by some stakeholders[24] that a higher standard of audit is undesirable on the basis that it will discourage transparency – that it will 'make directors think twice' before putting something in the annual reports, discouraging directors from including some statements or information for fear of challenge from the auditors. Our response is straightforwardly to question the value of statements or claims being put into company reports that the company's directors cannot back up, and that they do not think will stand up to scrutiny. This surely cannot be the type of 'transparency' that is desirable or useful. In our view this is in fact a positive feature of an enhanced audit – that directors *should* be thinking twice about including any given statement or information in a company report, and assessing whether it can stand up to scrutiny.

82. Stakeholders have pointed to broader problems with the effectiveness and suitability of the audit, and the existing audit profession, in verifying company information. First, steps can be taken, and are already being taken, to improve the effectiveness of the audit profession. Second, the fact remains that the information in company reports must be reliable, and that the audit is one of the few ways in which the reliability of information can be driven up (the other key way in our view being the proactive role of the regulator). To put the point simply, just because there are challenges involved, it does not change the fact that the job needs to be done.

83. Please see Annex 4 for further detailed discussion of the above.

iii. Guidance for directors

84. We consider that introducing practically-oriented guidance for directors on how to establish the processes necessary to prepare an OFR and achieve legal compliance would be valuable. This could be drawn from the 'Practical guidance for directors', prepared for the original OFR,[25] although we consider that it could be improved by a greater degree of cohesion with and cross-referencing to the statutory reporting standard and legislative requirements.

85. However, we stress that we do not view guidance alone as adequate to addressing the problems currently seen in company reporting, and to driving up reporting practice. Please see our comments under Q2 and 10 for further discussion.

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[24] 'The Future of Narrative Reporting Workshop' hosted by BIS, 27 September 2010.

[25] Department of Trade and Industry, 'The Operating and Financial Review: Practical Guidance for Directors' (May 2004) p. 11 at <http://webarchive.nationalarchives.gov.uk/tna/+/http://www.dti.gov.uk/cld/pdfs/ofr_guide.pdf/>

<u>Question 10:</u> 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?

86. For our purposes of seeking to drive better corporate practice in relation to environmental and social matters, among other ways by understanding and highlighting the relationship between environmental and social matters and business performance, we have not generally found the information in company reports on these matters to be of use to us (please see our comments under Q1, 4 and 6 for further detail).

87. However, we consider that a legal framework that *does* ensure that company reports contain high quality information on these matters is essential to the achievement of the government's objective of integrating enlightened shareholder value into corporate governance, and its stated manifesto commitment to ensure that directors' social and environmental duties have to be covered in company reporting.

ii. Could disclosure be improved? If so, how?

88. <u>Please see Annex 4 for detailed expansion on each of the points below</u>.

89. We consider that if the government is to:

    - adequately improve disclosure on the matters identified in question 10(ii), with particular reference to information on environmental matters, employees and social and community matters ('environmental and social matters'); and
    - fulfil its manifesto commitment to ensuring that directors' social and environmental duties have to be covered in company reporting;

    that the government should take the following steps.

90. As a top priority, the government must ensure:

    - **A powerful, transparent and accountable regulator that monitors compliance with legal requirements and is willing and able to take enforcement action where company reports do not comply with the law**

91. The government should also introduce:

    - **Statutory requirements to govern the way that KPIs are to be used in company reports**
    - **A statutory reporting standard, based on RS1 but which addresses a number of specific issues with RS1**

- **Detailed guidance for directors on the reporting process**
- **Statutory requirements for an enhanced mandatory audit of company reports, supplemented by support for initiatives geared to the improvement of the audit and audit profession**
- **Statutory requirements that oblige companies to set out the framework within which materiality judgements have been made for their reports**

92. The government should also give strong consideration to:

- **Introducing specific statutory requirements setting out a central group of environmental and social matters that must be covered in company reports, whether across the entire economy or within sectors**

93. Again, we emphasise our introductory comments that we do not consider that the one-in one-out system should apply to OFR reform, and further that *effectiveness* should be the determinative consideration in policy design, rather than burden.

iii. Are there key issues which are missing? If so, please explain?

94. Please see comments above.

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

95. We consider that introducing practically-oriented guidance for directors on how to establish the processes necessary to prepare an OFR and achieve legal compliance would be valuable. This could be drawn from the 'Practical guidance for directors', prepared for the original OFR,[26] although we consider that it could be improved by a greater degree of cohesion with and cross-referencing to the statutory reporting standard and legislative requirements.

96. With regard to best practice guidance or sample KPIs, in relation to environmental, social and possibly also economic matters, we consider that reference could be made to the Global Reporting Initiative's Sustainability Framework.[27]

97. To reiterate, we do not view guidance alone as adequate to addressing the problems currently seen in company reporting, and to driving up reporting practice. Please see our comments under Q2, 9 and 10 for further discussion.

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[26] Department of Trade and Industry, 'The Operating and Financial Review: Practical Guidance for Directors' (May 2004) p. 11 at <http://webarchive.nationalarchives.gov.uk/tna/+/http://www.dti.gov.uk/cld/pdfs/ofr_guide.pdf/>

[27] The GRI Sustainability Reporting Guidelines can be found at <http://www.globalreporting.org/NR/rdonlyres/B52921DA-D802-406B-B067-4EA11CFED835/3882/G3_GuidelinesENU.pdf>. This provides the overarching framework, which is supplemented by 'Indicator Protocols', setting out the indicators that should be used, and how they should be used, in relation to a range of environmental and social matters. These can be found at <http://www.globalreporting.org/ReportingFramework/ReportingFrameworkDownloads/G3GuidelinesIndividualDownloads.htm>. The GRI has also published a 'Boundary Protocol', for companies to draw appropriate lines around what can be considered their impacts or performance, rather than those of another company or entity. This can be found at <http://www.globalreporting.org/NR/rdonlyres/CE510A00-5F3D-41EA-BE3F-BD89C8425EFF/0/BoundaryProtocol.pdf>. GRI have also published sector supplements, which provide specialised guidance to secotrs that face particular challenges in relation to sustainability. These can be found at <http://www.globalreporting.org/ReportingFramework/SectorSupplements/>

<u>Question 12:</u> Should there be a shareholder's advisory vote on the Business Review?

98. Please see Q5 for our comments relating to the shareholders' advisory vote, noting in particular the emphasis placed in our comments on the need for broader and supplementary measures to be taken to enhance opportunities for public shareholder engagement.

<u>Question 13</u>: Are there non-regulatory solutions to increasing quality through better guidance or publicising excellence in business reports? If so, what?

99. We are keen to see the development of non-regulatory approaches to driving up reporting practice. For example, we strongly support the introduction of guidance relating to the way that the reporting process should be established (please see our comments under Q11 for further detail).

100. We would also welcome the introduction of initiatives such as official ranking systems or league tables, or any other such efforts, provided that they were good value for the necessary resource allocation.

101. However, we stress that in our view non-regulatory approaches are not and cannot be alternatives; in our view they serve different purposes and are able to achieve different ends.

102. In particular, non-regulatory initiatives that serve to drive up quality at the top-end of reporting practice must be underpinned by a regulatory framework that can *ensure* a certain minimum standard of reporting at the bottom. Regulatory and non-regulatory approaches are complementary rather than alternative options.

103. Key characteristics for useful information are accuracy, balance, completeness and reliability. Without these characteristics the value of information for shareholders, investors or others is very limited. These characteristics can only be ensured by a regulatory framework, implemented by a regulatory body adequate to the task.

<u>Question 14</u>: 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?

104. No comment.

<u>Question 15</u>: 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

105. We have no comment in relation to specific costs. Our only point in relation to this matter, other than those made in our introduction, is that when government is assessing the potential cost impact of various regulatory approaches, we consider that it should seek to take into account the financial performance enhancement and cost savings that can result from improved reporting and the higher standard of corporate stewardship that it can allow.

ANNEXES

Annex 1:
Analysis of the annual reports of the BP and Rio Tinto groups

In analysing the annual reports of a number of major UK based extractives companies, we have found forward-looking reporting to be lacking, and problematic. Case studies illustrate the problems observed.

BP's annual report

A clear and serious example can be drawn from the BP Group's Annual Reports and Accounts 2009. BP plc is the UK-registered parent company of the BP Group, one of the world's largest businesses. It reports under UK requirements, and its disclosures are regulated in UK jurisdiction.

When considering the discussion below, it is noteworthy that in a recent survey of the reporting of 'non-financial' matters by the FTSE100 companies, BP were identified as one of the 'best performing' companies.[28] Also of note is the often repeated view that the biggest companies provide the best reporting, and that the accuracy of their reporting is reliable on the basis of the scrutiny that they are subject to.

BP's long-term market outlook is of course a major issue for the long-term success of the business. Demand for its products and services will determine the company's future success. In describing the company's market outlook, the BP Report sets out the projections of the International Energy Agency's (IEA) 'reference scenario', drawn from the World Energy Outlook 2009. The BP Report then discusses the future of the company's business in the world projected by the reference scenario:

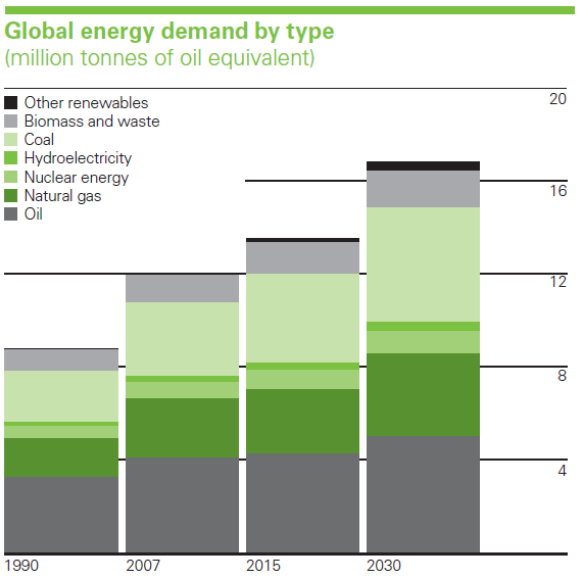
> *"Long-term outlook*
>
> *Recent economic conditions have weakened global demand for primary energy, but a number of forecasts predict a return to growth in the medium term. This is underpinned by continuing population growth and by generally rising living standards in the developing world, including the expansion of urban populations.*
>
> *Under the International Energy Agency's (IEA) reference scenario, global energy demand is projected to increase by around 40% between 2007 and 2030. That scenario also projects that fossil fuels will still be satisfying as much as 80% of the world's energy needs in 2030. At current rates of consumption, the world has enough proved reserves of fossil fuels to meet these requirements if investment is permitted to turn those reserves into production capacity. However, to meet the potential growth in demand, continued investment in new technology will be required in order to boost recovery from declining fields and commercialize currently inaccessible resources. For example, in oil alone, where we believe there are reserves in place to satisfy approximately 40 years' demand at current rates of consumption, we estimate that our industry will need to bring nearly 50 million barrels per day of new capacity onstream by 2030 if it is to meet the increased demand. To play their part in achieving this, energy companies such as BP will need secure and reliable access to as-yet undeveloped resources. We estimate that more than*

[28] Adrian Henriques, 'The reporting of non-financial information in annual reports by the FTSE100' (2010), p. 9 at <http://corporate-responsibility.org/wp/wp-content/uploads/2010/04/Reporting-of-Non-Financial-Information-by-the-FTSE1003.pdf>

80% of the world's oil resources are held by Russia, Mexico and members of OPEC – areas where international oil companies are frequently limited or prohibited from applying their technology and expertise to produce additional supply. New partnerships will be required to transform latent resources into much-needed proved reserves.

A more diverse mix of energy will also be required to meet this increased demand. Such a mix is likely to include both unconventional fossil fuel resources – such as oil sands, coalbed methane and natural gas produced from shale formations – and renewable energy sources such as wind, biofuels and solar power. Beyond simply meeting growth in overall demand, a diverse mix would also help to provide enhanced national and global energy security while supporting the transition to a lower-carbon economy. Improving the efficiency of energy use will also play a key role in maintaining energy market balance in the future."[29]

The BP Report's narrative discussion of long-term outlook is headed with a graphical representation of energy demand outlook to 2030, again containing projections drawn solely from the IEA reference scenario, titled 'Global energy demand by type':



Source: *World Energy Outlook 2009*. ©OECD/IEA 2009, page 622: 'Reference Scenario, World'.

The IEA's World Energy Outlook 2009 sets out two energy 'scenarios' – the 'reference scenario', and the '450 scenario'. The reference scenario sets out *"a baseline picture of how global energy markets would evolve if governments make no changes to their existing policies and measures"*,[30] while the 450 Scenario *"depicts a world in which collective policy action is taken to limit the long-term concentration of greenhouse gases in the atmosphere to 450 parts per million of -equivalent (ppm -eq), an objective that is gaining widespread support around the world"*.[31]

[29] BP Annual Report and Accounts 2009, p. 13 at <http://www.bp.com/assets/bp_internet/globalbp/globalbp_uk_english/set_branch/STAGING/common_assets/downloads/pdf/BP_Annual_Report_and_Accounts_2009.pdf>
[30] International Energy Agency, 'World Energy Outlook 2009: Executive Summary', p. 3 at <http://www.worldenergyoutlook.org/docs/weo2009/WEO2009_es_english.pdf>
[31] Ibid.

To emphasise the point, the IEA reference scenario is calculated on the assumption that governments make *no* changes to any policy that has bearing on the energy sector as of mid-2009.

The IEA reference scenario was never intended to be a likely or even plausible projection of future energy demand and supply, and the IEA World Energy Outlook 2009 highlights this point clearly, prominently, and several times [emphasis added]:

> *"Importantly, the Reference Scenario does not include possible, potential or even likely future policy initiatives, thus* ***it cannot be considered a forecast of what is likely to happen****. Rather, it is a baseline picture of how global energy markets would evolve if the underlying trends in energy demand and supply are not changed. This allows us to test quantitatively the possible effects of new government policies, as in the 450 Scenario."*[32]

> *"Part A of this WEO presents a comprehensive update of the energy projections in the Reference Scenario, which shows how the future might look on the basis of the policies so far adopted by governments.* ***These projections — which form the basis of all the discussion in Part A — are not a forecast: there is no implication that policy making has been brought to a sudden halt****. But examination of future trends on the basis of today's policies is a necessary starting point for deciding in what way and by what measures the future might be changed."*[33]

The IEA World Energy Outlook 2009 was also strongly framed in terms of the need for governments to take action to combat climate change – to avoid the reference scenario and its catastrophic consequences coming to pass:

> *"The rate of growth of fossil-energy consumption projected in the Reference Scenario takes us inexorably towards a long-term concentration of greenhouse gases in the atmosphere in excess of 1 000 ppm -eq. The concentration implied by the Reference Scenario would result in the global average temperature rising by up to 6°C. This would lead almost certainly to massive climatic change and irreparable damage to the planet...*
>
> *The Reference Scenario trends also heighten concerns about the security of energy supplies."*[34]
>
> *"Continuing on today's energy path, without any change in government policy, would mean rapidly increasing dependence on fossil fuels, with alarming consequences for climate change and energy security."*[35]
>
> *"The scale and breadth of the energy challenge is enormous... But it can and must be met."*[36]

[32] International Energy Agency, 'World Energy Outlook 2009' (2009) p. 55 [not accessible free of charge, and published with restrictions on sharing and distribution]
[33] International Energy Agency, 'World Energy Outlook 2009' (2009) p. 79
[34] International Energy Agency, 'World Energy Outlook 2009: Executive Summary', p. 6.
[35] International Energy Agency, 'World Energy Outlook 2009: Executive Summary', p. 6.
[36] International Energy Agency, 'World Energy Outlook 2009: Executive Summary', p. 3.

The IEA reference scenario is a *hypothetical baseline*, calculated on the basis of an assumption that is completely unrealistic, so as to provide a *reference* from which the government action can be designed. It is not, and was not intended to be, a realistic projection of future energy demand.

Yet the BP Report used figures drawn solely from this scenario to describe the future of its market to shareholders, and to provide the basis of which they must make an assessment of the future of the company.

The future of energy markets is a major issue not only for the planet, but for BP's business. The future of the company's market is essential context against which the company's strategy can be assessed, and will define the company's risks and opportunities in the future. The BP Report's treatment of the issue lacks balance and usefulness in the extreme. The fact that the BP Report dealt with this matter in such a way is an extremely concerning indictment of the effectiveness of the existing legal framework for company reporting.

Rio Tinto's annual report

Rio Tinto plc is one of the two parent holding companies of the Rio Tinto Group, a major multinational mining group. It is a UK-registered company.

As with BP, when considering the discussion below, it is noteworthy that in a recent survey of the reporting of 'non-financial' matters by the FTSE100 companies, Rio Tinto were identified as one of the 'best performing' companies.[37]

Our analysis of Rio Tinto's Annual Report 2008 highlighted a problem that we see recurring in company reporting, and that we have heard voiced as a major complaint by fund managers, other investment professionals and report users – the lack of linkage between the company's top-level strategy and identified strategic priorities and risks, and balanced detail in reports.

In company reports we have observed a recurring pattern whereby (1) operating in a sustainable or social and environmentally responsible manner is highlighted as a key strategic priority by a company; and (2) environmental and social issues or impacts are identified as relating to significant risks for the company; but (3) there is an absence of detailed, useful disclosure of facts or data on those matters.

For example, Rio Tinto's Annual Report 2008 (the 'Rio Tinto Report') identified the Group's core objective as:

> *"[T]o maximise the long term return to shareholders by finding, mining and processing metal and mineral resources across the globe."*[38]

It went on to identify four key areas of focus for achieving that core objective [emphasis added]:

> *"To deliver this objective the Group follows a long term strategy that concentrates on:*

[37] Adrian Henriques, 'The reporting of non-financial information in annual reports by the FTSE100' (2010), p. 9 at <http://corporate-responsibility.org/wp/wp-content/uploads/2010/04/Reporting-of-Non-Financial-Information-by-the-FTSE1003.pdf>

[38] Rio Tinto Annual Report 2008, p. 21 at <http://www.riotinto.com/documents/Rio_Tinto_2008_Annual_report.pdf>

- *The discovery of Tier 1, (large, low cost) orebodies that will safeguard our future cash flow.*
- *The development of Group assets into safe and efficient large scale, long life and low cost operations to ensure the Group can operate profitably at every stage of the commodity cycle.*
- *Operating in an ethical and socially responsible manner that maintains Rio Tinto's reputation and ensures ongoing access to people, capital and mineral resources.*
- *Putting long term sustainable development at the heart of everything the Group does."* [39]

The Rio Tinto Report went on to repeatedly emphasise the fundamental importance of these commitments to the ongoing success of the business. To take an example:

> *"Rio Tinto has a strong commitment to all aspects of sustainable development. This is an integral part of the way Rio Tinto conducts its business activities. By focusing on delivering economic prosperity, social wellbeing and environmental stewardship, within strong governance systems, we ensure sustainable development remains at the forefront. While this approach helps us to manage risk, our strong reputation as a socially responsible miner also continues to win us customer preference, giving us improved access to land, people and capital – the three critical resources upon which our business success is built."* [40]

Such issues were also identified as relating to key 'risk factors'. For example, with regard to community disputes and opposition, and the company's approach to community concerns:

> *"Political, legal and commercial instability or community disputes in the countries and territories in which the Group operates could affect the viability of its operations... Some of the Group's current and potential operations are located in or near communities that may regard such an operation as having a detrimental effect on their environmental, economic or social circumstances. The consequences of community reaction could also have a material adverse impact on the cost, profitability, ability to finance or even the viability of an operation. Such events could lead to disputes with national or local governments or with local communities and give rise to material reputational damage. If the Group's operations are delayed or shut down as a result of political and community instability, its revenue growth may be constrained and the long term value of its business could be adversely impacted."* [41]

Despite this recognition and emphasis, there was a lack of balanced information available in the Rio Tinto Report to allow shareholders to make an assessment of the company's performance in relation to these issues, or to understand how these risks were manifest during the financial year.

[39] Rio Tinto Annual Report 2008, p. 21
[40] Rio Tinto Annual Report 2008, p. 21
[41] Rio Tinto Annual Report 2008, p. 26

The Rio Tinto Report outlined a number of policies and programmes that it had initiated relating to community engagement and regional economic development.[42] It also provided a key performance indicator regarding 'community contributions'.[43] However, there was no information provided regarding actual community opposition to Rio Tinto operations, or the impact that that was having on the business.

For example, the La Granja reserve in Peru is estimated to be one of the largest copper reserves in Latin America.[44] In 2008, Rio Tinto was forced, as verified by Rio Tinto officials in print media, to suspend major aspects of its evaluation work, essentially grinding the development of the project to a halt, on account of large community protests.[45] Concerns around the environmental impacts of the development were cited.[46] The Rio Tinto Report did not detail these events, and indeed attributed its decision to scale back evaluation work to current economic conditions.[47]

At another of Rio Tinto's major investments, the Grasberg mine in West Papua, the mine was the target of a series of bombing attacks,[48] carried out by a Papuan independence group. These attacks were accompanied by a written statement from the independence group to the press calling for the closure of the mine.[49] Social conflict resulting from the mine, and environmental damage were cited explicitly as the motivation for these actions.[50] These events were not mentioned in the Rio Tinto Report.

Company reports need to provide detail on the negative as well as the positive if the information is to provide an accurate picture of the company's business, and to be useful to shareholders. Company reports that recognise at a general level that certain environmental or social matters are fundamental to the long-term success of the business, and the company's strategy, yet systematically fail to provide balanced detail in their reports as to how these matters are playing out in practice cannot be considered adequate.

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[42] Rio Tinto Annual Report 2008 p 85-86
[43] Rio Tinto Annual Report 2008 p 86
[44] Rio Tinto website, 'Inferred Mineral Resource at La Granja, Peru' (May 2008) at <http://www.riotinto.com/whatweproduce/17056_inferred_mineral_resource_la_granja_peru.asp>
[45] Bloomberg, 'Rio Tinto Suspends Peru Copper-Plant Construction on Protests' (20 October 2008) [no longer accessible on line]; Reuters, 'Rio Tinto suspends Peru construction after protest' (20 October 2008) at <http://www.reuters.com/article/idUSTRE49J7LE20081020>
[46] *Ibid*.
[47] Rio Tinto Annual Report 2008, p. 30 at <http://www.riotinto.com/documents/Rio_Tinto_2008_Annual_report.pdf>
[48] Blair Price, 'Papuan independence group behind Grasberg bomb blasts' *MiningNews.net* (16 September 2008) at <http://www.miningnewspremium.net/StoryView.asp?StoryID=269686>
[49] Reuters, 'Indonesia's Papua rebels seek closure of Freeport mine' (15 September 2008) at <http://in.reuters.com/article/idINIndia-35482220080915>
[50] Reuters, 'Indonesia's Papua rebels seek closure of Freeport mine' (15 September 2008)

Annex 2:

Relevant excerpts from: Department of Trade and Industry, 'The Operating and Financial Review: Practical Guidance for Directors'

Under the previous OFR framework, guidance was developed and published to help directors to establish the processes necessary to write their OFRs, to make materiality judgements, and to comply with the law. The guidance was developed by an esteemed multi-stakeholder working group[51] and following extensive consultation. That guidance placed strong emphasis on the need for directors to look beyond their board agendas from the past year in considering what is to be included in company reports. It also emphasised the role of company reporting in driving improved strategic decision-making and practice.

The second section of the guidance was headed 'The starting point for directors' (in the reporting process), and it set out some considerations that directors should take into account when assessing what should be included in their OFR. It is instructive of the role that reporting can and, in our view, should play in driving corporate decision-making [emphasis added]:

> *"The knowledge and experience of the board as a whole has to be such as to ensure that sound judgements can be made about the OFR. This knowledge and experience, however, can be equated to what is anyway needed to run the company in the best interests of its members.*
>
> *Example I.3*
> *The fact that the knowledge and experience required to make sound judgements about the OFR are the same as the knowledge and experience needed to run the company in the best interests of its members means that, potentially, the OFR should reflect the strategic issues that are in any case on the board's agenda.* ***If the directors find that additional issues not hitherto regarded as significant do in fact merit inclusion in the OFR then they will want to examine why they have not featured on the board's agenda previously and ensure that they are subject to a greater degree of review in the future. In this way preparation of the OFR can act as a catalyst for improved strategic decision-taking.***
>
> *The balance of skills and competencies available to the board, both from amongst the directors themselves and from advisers and others, will also need to be adequate in relation to all the issues that, potentially, may need to be covered in the OFR.* ***Because of the necessarily broad coverage of the OFR, some issues may require access to additional skills and competencies in areas not previously recognised as being needed.***

[51] Rosemary Radcliffe CBE, Economist and member of the Company Law Review Steering Group; Gerry Acher CBE LVO, Chairman, Company Reporting Working Party, Advisory Committee for Business and the Environment; Deborah Doane, Chair, Corporate Responsibility Coalition; Mark Goyder, Director, Tomorrow's Company; Phil Hodkinson, Chief Executive, Insurance & Investment Division, HBOS Plc; Mary Keegan, Chairman, Accounting Standards Board; Rob Lake, Head of SRI Engagement and Corporate Governance, Henderson Global Investors; Graham Ward, Senior Partner, Global Energies & Utilities Group, PricewaterhouseCoopers and Deputy President of The International Federation of Accountants.

Example I.4
It has been stressed to us that this is a live issue for many boards. Assessing the significance of some of the issues mentioned in the Regulations as possible candidates for inclusion in the OFR, such as environmental matters or social and community issues, may require access to additional skills and competencies: this is well established in some companies but by no means in all. Appointing non-executive directors from a range of backgrounds, including non-corporate backgrounds, or the use of special independent Advisory Panels, for example for Social Responsibility, are examples of strategies that businesses are using to address the issue."[52]

The guidance also directly addressed the role that the board's agenda from the past year should play in information-gathering during the reporting process, stressing the importance of a whole range of other sources [emphasis added]:

"What do other sources suggest might be important and should be considered for inclusion? [beyond the matters outlined in legislative requirements]
Information already available within the business constitutes a key source. For businesses who are already preparing OFRs, reviews prepared in earlier years will be very important. The current year's OFR should follow up statements made in earlier OFRs, reporting progress or explaining divergences. Important for all businesses will be all the financial and operating statements made in the year*, and any public statements or press releases. A further very important source will be the board's own agenda: the matters that have occupied the board in the past year will be a good, though not always a perfect, guide to what have, in practice, been key issues affecting performance and prospects.*

External sources will also be important. Relevant here will be the OFRs of other companies, particularly those operating in similar business areas, but also industry guidance and models of best practice in each of the broad topic areas potentially covered by the OFR.

Businesses with significant groups of key stakeholders are also likely to benefit from the results of consultation with these groups to ascertain what, in their view, are the key issues. This may take the form of feedback on earlier OFRs (which can usefully be obtained each year – see Q.10 below) but also from surveys or workshops with groups of key stakeholders. Boards are increasingly seeking to go beyond conventional information sources and seek out new approaches by which, for example, they may be able to engage affected stakeholders in a more formal manner."[53]

In our view, this guidance adopted a proper and sensible approach to the role of reporting in corporate practice, striking the correct balance for a report both to reflect management's existing view of the company and to drive management practice.

[52] Department of Trade and Industry, 'The Operating and Financial Review: Practical Guidance for Directors' (May 2004) p. 11 at <http://webarchive.nationalarchives.gov.uk/tna/+/http://www.dti.gov.uk/cld/pdfs/ofr_guide.pdf/>
[53] Department of Trade and Industry, 'The Operating and Financial Review: Practical Guidance for Directors' (May 2004) p. 22

The reporting process should stretch directors and companies to consider matters that they may not have previously considered, and to assess their significance to the long-term success of the business, taking the nuanced view of success – 'enlightened shareholder value' – that was intended by the Companies Act 2006, and that remains the priority of the current government.

Annex 3:

Detailed discussion of comments in Q9 re RS1

As stated in our consultation response under Q9, we strongly support the introduction of a reporting standard against which narrative reports must be developed, that gives detailed expansion on legislative requirements, and can assist directors in understanding how they are expected and required to report.

RS1 provides a good starting point for the development of a new statutory reporting standard. However, in our view it requires reassessment in certain regards.

RS1: objective standards

The first principle set out by RS1 is that *'The OFR shall set out an analysis of the business through the eyes of the board of directors'*.[54] Later, in explaining the 'Disclosure framework, RS1 states that '*It is for directors to consider how best to use the framework to structure the OFR and the precise content, including the level of detail to be disclosed, relating to the key elements, given the particular circumstances of the entity*'.[55]

It should be made clear to directors that when company reports are being assessed for compliance with legal requirements, that the assessment will be that of what the reasonable director would have considered necessary to satisfy compliance with legal requirements. The provisions of RS1 highlighted above could be taken to suggest that directors are at liberty to exclude issues or information even where any reasonable director would consider their inclusion necessary to satisfy the legal requirements that reports constitute a fair review of the company's business, and a balanced and comprehensive analysis of the development, performance and position of the company's business.

Any statutory reporting standard should stress the objective standards of care, skill and diligence required of directors when preparing company reports, and against which the compliance of reports will be judged.

To take an example: an oil and gas company's directors do not consider climate change to be a relevant issue to the future of their business, despite indisputable evidence to the contrary, and so ignore it completely in their company reports, or paint a picture of the issue to shareholders that is superficial or misleading. It should be clear from any statutory reporting standard that such reports will not be compliant with the law – regardless of whether it constitutes an analysis of the business through the eyes of the board of directors, or whether the directors considered the report to adequately disclose information on environmental matters as relevant and material to the business.

Further, while we agree that company reports should to an extent reflect the way that the directors view the business, the reporting process should also push management to think beyond their existing view of the business and what is relevant to it (see comments in Q3 above).

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[54] Accounting Standards Board Reporting Standard 1: Operating and Financial Review para 5 at <http://www.frc.org.uk/images/uploaded/documents/Web%20optimized%20OFR%20REPORTING%20STANDARD.pdf>

[55] Accounting Standards Board Reporting Standard 1: Operating and Financial Review para 27

RS1: forward-looking orientation; environmental and social matters

We strongly support the forward-looking and long-term emphasis of RS1. Under the Companies Act 2006 regime, there is little in law or guidance that adequately conveys the long-term nature of the reporting requirements, and the need for reports to address business success through the prism of 'enlightened shareholder value'.

However, in our view RS1 did not sufficiently emphasise the connection between the obligations on companies to report on environmental and social matters, and the long-term outlook of the OFR. We consider that any statutory reporting standard should explicitly address the ways in which environmental and social matters are to be considered relevant to the business: that they must be considered beyond the short-term context, and their quantifiable short-term materiality, looking primarily to the long-term role that such matters play in shaping a company's business and its success.

The non-binding 'implementation guidance' that accompanied RS1 addressed this point to a degree:

> "*...where the management of a particular matter* [e.g. employees or the environment] *could significantly affect the entity's ability to successfully implement its strategies or the entity's short or long-term value, that matter shall be addressed within the OFR."* [56]

In our view statements to this effect should be included in a new binding statutory reporting standard, so as to give appropriate emphasis to this point.

We also consider that a statutory reporting standard should place greater emphasis on the specific environmental and social matters that may need to be discussed in company reports in order for them to achieve compliance with legal requirements.

Emphasis should also be placed on the way in which environmental and social issues must be reported: discussion of the issues in a broad sense and how they relate to the business; the policies the company has in place to manage or address the issues; and information (both good and bad) that allows an informed assessment of the development, performance and position of the company in those regards (please see comments in Q1).

RS1: materiality judgements

In our view a new reporting standard should explicitly address the issue of materiality, stressing the way in which the principles and rules of a reporting standard, and the purpose of the business review / OFR, define the way in which companies should be approaching materiality judgements.

For example, the following principles of RS1 have clear bearing on the way that judgements should be made about whether information should or should not be considered material and included in reports as such:

[56] Accounting Standards Board Reporting Standard 1: Operating and Financial Review Implementation Guidance para IG9 at <http://www.frc.org.uk/images/uploaded/documents/Web%20optimized%20OFR%20REPORTING%20STANDARD.pdf>

"The OFR shall have a forward-looking orientation, identifying those trends and factors relevant to the members' assessment of the current and future performance of the business and the progress towards the achievement of long-term business objectives." [57]

"The OFR shall be balanced and neutral, dealing even-handedly with both good and bad aspects." [58]

The statutory purpose of the business review, with its link to the directors' duties to promote the success of the company and enlightened shareholder value, also has major implications for how materiality judgements must be made in order for reports to be compliant with the law. These implications should be set out in any reporting standard.

RS1: joined up reporting between strategy and performance

We also consider that any new statutory reporting standard should emphasise the need for company reports to follow through on statements regarding strategic priorities, risks and opportunities with detailed information that allows for an informed assessment of the company's performance specifically in relation to those matters. As discussed under Q1, we consider this to be a problem in current reporting practice. RS1 did not emphasise this matter, and in our view a new statutory reporting standard should do so.

RS1: Key Performance Indicators

RS1 included a number of provisions relating to the use of KPIs in company reports. We strongly support the original OFR framework's emphasis on the need for quantitative indicators to be clearly explained and understandable, and to be used consistently across reporting cycles.

In our view the provisions of RS1 relating to KPIs should be introduced as legislative requirements. As part of RS1, if companies did not report according to these provisions, they had to state as much and explain why. This is greatly preferable to the existing legal position, but we consider that companies should be required to use KPIs in accordance with these requirements unless a clear and reasonable *justification* can be given as to why they could not do so.

Please see Annex 4 for further discussion.

RS1: evidencing claims

We also strongly support the emphasis placed in RS1 on the need for reports to explain and contextualise *any* assertions made or information provided, in terms of the need to discuss the evidence underpinning any claim and the degree to which the assertions or information in company reports are objectively supportable.[59]

[57] Accounting Standards Board Reporting Standard 1: Operating and Financial Review para 9
[58] Accounting Standards Board Reporting Standard 1: Operating and Financial Review para 23
[59] Accounting Standards Board Reporting Standard 1: Operating and Financial Review para 20

Annex 4:

Detailed discussion of comments in question 10(ii)

We consider that if the government is to:

- adequately improve disclosure on the matters identified in question 10(ii) of the consultation on the Future of Narrative Reporting, with particular reference to information on environmental matters, employees and social and community matters ('environmental and social matters'); and
- fulfil its manifesto commitment to ensuring that directors' social and environmental duties have to be covered in company reporting;

that it should take the following steps.

i. <u>To ensure, as a top priority:</u>

- **A powerful, transparent and accountable regulator that monitors compliance with legal requirements and is willing and able to take enforcement action where company reports do not comply with the law**

  In order for the law to be effective, it must be enforced. If the law cannot be or is not enforced, in practical terms the legal requirements as to what company reports must include are rendered little more than guidance. An effective legal framework must include structures and procedures that can monitor compliance with the law and enforce it where necessary.

  In our view considerably more could have been achieved in driving up the quality of company reports under existing business review requirements,[60] had an active and robust approach been taken by the FRRP. This is by no means to say that improvements to that legislative framework are not needed, but it is to emphasise the vital role that enforcement plays in this regulatory framework.

  The FRRP's role is particularly crucial on account of the fact that under the current legal framework, the FRRP is the only person or body, other than the Secretary of State, that has the legal powers and resources necessary to investigate, pursue and secure compliance by companies with reporting requirements.

  We understand that the government is currently considering the merger of the UK Listings Authority with the Financial Reporting Council (under which the FRRP operates). We have no comment on this matter, other than to say that we strongly support the establishment of a powerful, adequately resourced, active and transparent regulator that can effectively regulate corporate disclosure in annual reports and ensure compliance with legal requirements.

  Please see our comments under Q2 and 5 of our consultation response for further discussion of the vital importance of this role.

[60] Specifically in relation to the central business review requirements that reports constitute a fair review of the business, and a balanced and comprehensive analysis of the development, performance and position of the company's business, as these requirements would have been seen by the 'reasonable director'.

ii. To introduce:

- **Statutory requirements to govern the way that Key Performance Indicators (KPIs) are to be used in company reports**

  We consider KPIs to be an essential part of 'non-financial' reporting, alongside the narrative. They should provide concise and solid data on which company performance can be judged on non-financial issues. However, the way that KPIs are used and explained is essential to their value. Other than in the case of the simplest of indices, unless KPIs are properly contextualised and explained, and are used consistently, their usefulness to shareholders and other report users is highly limited, and they may even present a misleading picture to those users.

  RS1 included a number of specific non-mandatory 'comply or explain' provisions relating to the use of KPIs. RS1 provided[61] that where a KPI was used:

  - the definition and its calculation method shall be explained;
  - its purpose shall be explained;
  - the source of underlying data shall be disclosed and, where relevant, assumptions explained;
  - quantification or commentary on future targets shall be provided;
  - where information from the financial statements has been adjusted for inclusion in the OFR, that fact shall be highlighted and a reconciliation provided;
  - where available, corresponding amount for the financial year immediately preceding the current year shall be disclosed; and
  - any changes to KPIs shall be disclosed and the calculation method used compared to previous financial years, including significant changes in the underlying accounting policies adopted in the financial statements, shall be identified and explained.

  In our view these provisions should be introduced as statutory requirements, to be applied in all circumstances unless justification can be given as to why they could not be.

- **A statutory reporting standard, based on RS1 but which addresses a number of specific issues**

  We strongly support the introduction of a statutory reporting standard, developed from RS1. However, as discussed in Annex 3, we consider it crucial that a new reporting standard should stress:

  - the objective nature of the central business review requirements, and the objective standards of care, skill and diligence required of directors when preparing company reports, and against which the compliance of reports will be judged;
  - the connection between environmental and social disclosures and the OFR's forward-looking orientation;

[61] Accounting Standards Board Reporting Standard 1: Operating and Financial Review para 20 at <http://www.frc.org.uk/images/uploaded/documents/Web%20optimized%20OFR%20REPORTING%20STANDARD.pdf>

- the environmental and social issues that may need to be reported on in order to be compliant with legislative requirements, and how they must be reported;
- key factors that will define the way that materiality judgements are to be made;
- the need for joined up reporting between strategy and performance.

In the case that the government introduced disclosure requirements regarding specific environmental or social issues (as discussed below under iii.), we consider that it would also be necessary for the statutory reporting standard to make clear that beyond whatever specific environmental and social matters have been mandated as per above, that directors must carefully consider what *other* environmental and social matters must be reported on, on account of the company's specific business.

- **Detailed guidance for directors on the reporting process**

We consider that introducing practically-oriented guidance for directors on how to establish the processes necessary to prepare an OFR and achieve legal compliance would be valuable. This could be based loosely on the 'Practical Guidance for Directors' prepared for the original OFR[62] (including its emphasis on the reporting process driving improved strategic decision-making), but we consider that that guidance could be improved by a greater degree of cohesion with and cross-referencing to the statutory reporting standard and legislative requirements.

With regard to best practice guidance or sample KPIs, in relation to environmental, social and possibly also economic matters, we consider that reference could be made to the Global Reporting Initiative's Sustainability Framework.

- **Statutory requirements for an enhanced mandatory audit of company reports, supplemented by support for initiatives geared to the improvement of the audit and audit profession**

We view the reliability of information in company reports as of the upmost importance to effective corporate governance, and as such consider that an enhanced mandatory audit is necessary (please see our comments under Q9 of our consultation response for further discussion).

Auditors can and should assess the narrative reports of companies. Subjective views and judgements can be audited in shades of grey – it is clear that no binary of truth / falsity can be found in relation to many matters dealt with in company narrative reports, relating as they do to the judgements of directors. Forward-looking information also presents particular challenges. However, auditors can and should examine and report on whether the assumptions underpinning directors' judgements are sound and transparent, and exercise professional judgement to qualify directors' statements and views, and identify points of caution for shareholders. In the study conducted by ICAS referred to in our consultation response,[63] interviewees expressed a clear frustration with boilerplate or 'tickbox' audit reports, and a desire for audit reports that operate in these areas of grey,

[62] Department of Trade and Industry, 'The Operating and Financial Review: Practical Guidance for Directors' (May 2004) p. 11 at <http://webarchive.nationalarchives.gov.uk/tna/+/http://www.dti.gov.uk/cld/pdfs/ofr_guide.pdf/>
[63] Fraser I, Pierpoint J, Collins B, Henry W, 'Meeting the needs? User views on external assurance and management commentary' (June 2010) at <http://www.icas.org.uk/site/cms/contentviewarticle.asp?article=6852>

and provide this level of nuance. Audit reports of this type would also help to act against managerial bullishness and spin, one of the key perceived problems with company reports identified by the ICAS study.

Non-financial Key Performance Indicators can and should be audited. KPIs are constituted of quantitative information, based on data and fact. Auditors can examine the data on which the KPI is based, in the context of the assumptions by which that KPI is calculated, and make an assessment of whether that KPI is accurate. Auditors can also offer a view, based on professional judgement, as to whether that KPI has been defined in such a way that it adequately reflects the issue that the company has sought to illustrate, and can identify any aspects of that KPI's design and definition that might undermine its relevance in illustrating the given point.

We see little value in an audit of process alone. We support an outcome-oriented, judgement-based audit report – audit of systems and processes are useful, but in our view the audit should also be focused on the substance of reports, whether quantitative or qualitative. We understand this to be a view increasingly shared by investors and other report users.

Regarding the adequacy of the audit profession to play this role in company reporting, there are a number of initiatives already underway geared towards strengthening the role that the audit plays in the financial system. For example:

- The European Commission's consultation and green paper, 'Audit Policy: Lessons from the Crisis' (published October 2010);[64]
- The Auditing Practices Board's discussion process, based on its paper 'Auditor scepticism: Raising the bar' (published August 2010);[65]
- The Financial Services Authority & Financial Reporting Council's discussion process, based on their paper 'Enhancing the auditor's contribution to prudential regulation' (June 2010).[66]

The government can give support to and draw from these processes to enhance the role that audit can play in strong corporate governance and the provision of reliable information in company reports.

The profession can also develop, and is already developing, the specific skills and understanding necessary to audit disclosures on environmental and social matters, and to exercise professional judgement and professional scepticism in relation to environmental and social matters. UK audit firms are already playing major roles in the development of the frameworks that measure company performance in relation to these issues, and the impact that they have on businesses.[67] We consider that if a greater market is created for

[64] European Commission, 'Audit Policy: Lessons from the Crisis' COM(2010) 561 final at <http://ec.europa.eu/internal_market/consultations/docs/2010/audit/green_paper_audit_en.pdf>

[65] Auditing Practices Board, 'Auditor scepticism: Raising the bar' (published August 2010) at <http://www.frc.org.uk/images/uploaded/documents/Discussion%20paper%20Auditor%20Scepticism%20-%20raising%20the%20bar21.pdf>

[66] Financial Services Authority & Financial Reporting Council, 'Enhancing the auditor's contribution to prudential regulation' (June 2010) at <http://www.frc.org.uk/images/uploaded/documents/FSA%20FRC%20Discussion%20paper1.pdf>

[67] For example, see PwC's involvement in the development of 'TEEB (The Economics of Ecosystems and Biodiversity) for Business', TEEB – The Economics of Ecosystems and Biodiversity Report for Business at <http://www.teebweb.org/ForBusiness/tabid/1021/Default.aspx>

such work, the profession will develop further skills and understanding. This can also be supported through formal professional training and education initiatives.

- **Statutory requirements that oblige companies to set out the framework within which materiality judgements have been made for their reports**

  A disclosure that sets out the process by which a board has arrived at what is or is not material, including details of the assumptions on which materiality judgements have been made (e.g. timeframe of reference), would be extremely valuable information. It would allow shareholders far better context for the information being presented, would provide a strong insight into the outlook of the company directors and how they are approaching their duty to promote the success of the company, and would allow more effective challenge by shareholders where they consider that a matter has not been adequately or appropriately addressed in reports. We have heard strong support for transparency on this matter from investors.

  As such, in our view a statutory requirement on companies to disclose this information should be introduced.

iii. <u>To give strong consideration to:</u>

- **Introducing specific statutory requirements setting out environmental and social matters that must be covered in company reports, whether across the entire economy or within sectors**

  If the OFR is to achieve the government's stated goal of ensuring that directors' social and environmental duties have to be covered in company reporting, we consider there to be a strong case for requirements that the environmental and social matters most broadly and fundamentally relevant to UK business and the UK economy – for example climate change,[68] biodiversity, water use, employee and labour issues, health and safety, community impacts – be reported on by all listed companies.

  Such mandatory requirements would indeed create 'box-ticking', but strategically significant box-ticking that is comparable between companies and across years. As discussed in our consultation response under Q7, there is no reason that such mandatory disclosures could not sit alongside a company's 'individual' narrative, or that such requirements would threaten to turn the entire reporting process into a box-ticking exercise.

  Consideration should be given to which environmental and social matters are so fundamental to the future of the UK and global economy, and of such broad relevance to UK business that all companies should report on them. Tools have been developed to aid coherent assessment of which sustainability issues are of such relevance across a given group of companies, for instance 'From Transparency to Performance: Industry-Based Sustainability Reporting on Key Issues', Steve Lydenberg et al, Harvard University, June 2010.[69]

[68] Noting the government's current consideration of specific requirements relating to climate change-related disclosures, as a result of obligations under the Climate Change Act 2008.

[69] Lydenberg S, Rogers J, Wood D, 'From Transparency to Performance: Industry-Based Sustainability Reporting on Key Issues' (2010) at <http://hausercenter.org/iri/wp-content/uploads/2010/05/IRI_Transparency-to-Performance.pdf>

There are also a number of sophisticated frameworks already in existence that define and delineate how specific disclosures relating to environmental and social issues can and should be made. The Global Reporting Initiative's 'Sustainability Reporting Framework'[70] appears to be the most detailed, widely recognised and respected of these.

A great deal of work as to how these issues can be measured and reported, and how policy-makers can identify the most relevant and material disclosures for a given group of companies, has already been done: many of the tools are there for this task.

These requirements could be introduced as 'enhanced' comply or explain requirements, whereby companies are required to report on those matters unless they provide explanation as to why they have not been considered relevant to the business. In this regard it is noteworthy that if companies have established the appropriate processes for reporting, and deciding what issues are material and to be included in reports (as described, for example, in the guidance to directors under the OFR),[71] a great deal of the information and explanation will already exist internally as to why and how it was decided that a given issue was not material. A 'comply or explain' disclosure requirement to this effect would therefore not necessarily create a major burden on companies.

Were such requirements to be introduced, it would be necessary for a statutory reporting standard to stress that these environmental and social disclosures are the minimum required, that directors must carefully consider what *other* environmental and social matters must be reported on, given the specific nature of the company's business and the broader statutory reporting requirements.

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[70] The GRI Sustainability Reporting Guidelines can be found at <http://www.globalreporting.org/NR/rdonlyres/B52921DA-D802-406B-B067-4EA11CFED835/3882/G3_GuidelinesENU.pdf>. This provides the overarching framework, which is supplemented by 'Indicator Protocols', setting out the indicators that should be used, and how they should be used, in relation to a range of environmental and social matters. These can be found at <http://www.globalreporting.org/ReportingFramework/ReportingFrameworkDownloads/G3GuidelinesIndividualDownloads.htm>. The GRI has also published a 'Boundary Protocol', for companies to draw appropriate lines around what can be considered their impacts or performance, rather than those of another company or entity. This can be found at <http://www.globalreporting.org/NR/rdonlyres/CE510A00-5F3D-41EA-BE3F-BD89C8425EFF/0/BoundaryProtocol.pdf>. GRI have also published sector supplements, which provide specialised guidance to secotrs that face particular challenges in relation to sustainability. These can be found at <http://www.globalreporting.org/ReportingFramework/SectorSupplements/>.

[71] Department of Trade and Industry, 'The Operating and Financial Review: Practical Guidance for Directors' (May 2004) at <http://webarchive.nationalarchives.gov.uk/tna/+/http://www.dti.gov.uk/cld/pdfs/ofr_guide.pdf/>

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