The Future of Narrative Reporting

Consultation Response

Name:	Ian L McDonald Wood
Organisations:	Futurevalue and The Strategic Planning Society

Types of organisation:

FutureValue	Other – Narrative Reporting Research Firm
The Strategic Planning Society	Other – Educational charity

Ian McDonald Wood is the Director of FutureValue and Chairman of the Strategic Planning Society. The Board of Trustees of the Society has approved and endorsed this consultation response.

VALUE OF NARRATIVE REPORTING

Question 1: Are company directors providing useful and relevant information on the company's:
i) forward-looking strategy? and
ii) principal risks and uncertainties?

The quality of information provided across the FTSE350 in respect of strategy and risks and uncertainties is variable.

In 2009 FutureValue's analysis of declared strategic goals revealed that more than a quarter of FTSE350 companies stated their only goal was a generic 'increase in shareholder value'. This offers little insight to anyone, fails to indicate strategic direction and frequently renders the underlying strategy questionable. UK companies are generally weak at presenting strategy. This is particularly notable at Group level where the majority of groups of companies seem unable to show how the 'group' is worth more than the mere sum of its parts, the underlying divisions or business units.

All too often the reporting of risks and uncertainties concentrates on the risks of simply being in business rather than factors that might be prejudicial to achieving strategic objectives. The worst reporting of risks and uncertainties is among dual-listed companies reporting to SEC 20-F rules in a dual-purpose corporate report embracing UK and US reporting. These typically include nothing on risk mitigation, specific management or strategic context.

There are some exemplars in reporting strategy and risks and uncertainties, usually as elements of a cohesive discussion of strategic added value. These exemplars typically achieve good first quartile scores in the FutureValue Strategic Value Ranking.

FutureValue assesses the quality of strategic value added by listed companies in their Annual Reports on a comparative basis as an effective indicator of future potential. The Strategic Planning Society also uses the FutureValue research to recognise the companies with very best reporting strategy in its annual 'Strategic Value in Corporate Reporting' Awards.

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

There are two principal constraints in our opinion.

Many companies attach limited value to their Annual Reports citing that virtually no-one reads them. If this is to some extent true and there is a more limited interest in Annual Reports, it has become to some extent a self-fulfilling prophecy. Layers of regulation, standards and guidance from disparate standard setters, regulators and professional bodies have contributed to fragmentary documents of unnecessary complexity. This 'no-one reads them' attitude has to contrast with the more positive attitude of those companies that consider their Annual Report specifically to be a valuable resource from which they benefit.

Evaluation of Annual Reports of UK listed companies over several years has confirmed to FutureValue that another principal constraint is a weakness in rigorous strategic thinking by Boards and their managers. It is important to remember that strategy as a management science and business technique is only thirty years old. Many UK Directors will only have learned of strategy in the last two decades, if that, and for many this may well have come in the latter stages of their careers. Strategy remains for the time being an emergent management science that has yet to mature into a progressive and dynamic professional discipline. This does not understate the vital importance of strategy as the key to future potential, and its importance in narrative reporting. It lacks yet perhaps the universal standards and precision of other professional disciplines. This may conceivably erode its perceived value to the more recalcitrant Boards. Many seem equally unable to take a strategic approach to risk and uncertainties.

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

We cannot say with complete certainty but 'probably not' is the answer. Companies appear even less inclined to report in their reporting narratives about the processes by which their Boards engage in the formulation, review and implementation of strategy and the consequent measurement of strategic performance. Coverage of Board engagement in the strategy processes is all too often little more than a compliance comment in the corporate governance statement to say that these things [strategy et

al] are reserved for the Board. Generally, this narrative shortcoming represents an omission in the layers of regulation and best practice guidance. Best practice and regulation both focus on content leaving key Board processes to corporate governance and the combined code. But, corporate governance (even in the new UK Code) does not ask for the Board's strategic thinking and involvement in management processes – just the business model. Typically, there is more on risk management governance and processes and the Board's involvement in narrative reports. More often than not, this is also to be found in the corporate governance statement.

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

There is a broad correlation between the quality of strategic value added in narrative reporting and market performance relative to a company's sector. This indicates that really good, well-articulated narrative is able to project clearly a company's future potential and informs business decisions. In the view of one of our clients it reduces stock market volatility at the very least.

FutureValue knows that asset managers and owners use FutureValue's analysis of strategic value added by companies in their Annual Reports as an aid to their engagement with those companies. It should be possible for any company with clear strategic thinking to articulate that effectively such that even the least expert retail investor can understand and feel able to question the Company on its direction. Only a very few companies currently match up to this standard. Many people are misled into thinking that narrative in Annual Reports is audited and that only corporate social responsibility sections are not. Auditors are not qualified to audit the finer strategic points of narrative, they are only qualified to confirm that the information given is consistent with the accounts.

Question 5: If a company does not provide sufficient or material information to you, do you challenge it? Is there anything which could help you to do so?

A number of companies purchase FutureValue's analysis of their Annual Reports – Strategic Value Profiles – to be able to assess the quality of their own narrative reporting with a view to improving it. Some asset managers and owners also use these Strategic Value Profiles – generally considered to be authoritative, independent and objective – to help them in their engagement process with their investee. FutureValue's analysis is unique. Narrative reporting remains for the time being undervalued generally. It is not FutureValue's business to challenge companies on the quality of their narrative, unless our clients ask us to do so.

Question 6: What other sources of company information do you use and how valuable are they (e.g. information provided on the website, analysts' briefings, dialogue with the company, corporate social responsibility report)?

FutureValue uses only the Annual Report. As this is produced in every case to the minimal requirement of the Companies Act 2006 or to the best practice standard of Reporting Statement 1, the content is comparable between companies, in the same way as the numbers in P&L Accounts and Balance Sheets that constitute historical performance are comparable. No other corporate reporting document is comparable in the same way. We refer to PDF versions of the print reports.

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

There is considerable opportunity to simplify the requirements from a narrative perspective. There needs to be clarity and agreement among regulators and standard setters as to the purpose and scope of narrative reporting first. Imposed regulation will not be the answer. This needs to be freed up from the hands of accounting firms and accounting bodies if it is to be simplified.

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

There is a groundswell of thinking around integrated reporting, bringing together sustainability, governance and strategy elements. An integrated format should help companies to differentiate more clearly the quality of their respective strategic thinking, enabling the most effective to project a more integral strategic focus that demonstrates the added strategic value analysts and investors are looking for in making their decisions. We collectively need to restore the perceived value of the Annual Report narrative so that investors, stakeholders and companies value it as the incontrovertible primary source of information on the future direction and potential of a company.

BUSINESS REVIEW

Question 9: Looking at an Operating & Financial Review and the existing business review (see Annex D), do you see value in reinstating elements of an OFR and if so what would they be? In particular, would a statutory reporting standard help to improve the quality of reporting?

There is merit in introducing a more compulsory requirement for companies to:

- present and discuss their strategic thinking or at least to present their vision, business objectives and strategies for the Group and separately for its reportable segments
- comment on how performance and KPIs in the period under report indicate effective strategic management, i.e. show strategy in action
- provide a better indication of a company's sensitivity to its future beyond the next trading period so as to indicate the achievability of its goals and effectiveness of its strategies - this includes risks and uncertainties
- indicate clearly how integral social, ethical and environmental matters are to the strategy of a company.

The current Best Practice OFR requires most but not all of the above. It is important not to sacrifice the comparative advantage of the principles-based framework approach inherent in UK corporate reporting.

Question 10: The business review provisions require quoted companies to report, to the extent necessary, on:

- **main trends and factors likely to affect the future development, performance and position of the company's business**
- **information on environmental matters**
- **information on employees**
- **information on social and community matters**
- **persons with whom the company has essential contractual and other relationships**

i) Is this information useful to you? How do you use it?
ii) Could disclosure be improved? If so, how?
iii) Are there key issues which are missing? If so, please explain?

This information is very useful. It comprises the closest there is to the elements of a strategy discussion in the rather vague, non-specific wording of the Enhanced Business Review. We have explained earlier how FutureValue uses this information in strategic value analysis and in question 9 how this should be upgraded.

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

One or two examples of an integrated report narrative would be useful. Ideally, there should be one per sector. Companies are too hidebound by conventional [and fragmentary] reporting formats to feel they can be more creative in this.

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

No. Analysts and investors have the opportunity to make up their own minds individually on the quality of what a company presents. The prospect of an advisory vote may well dumb down the content a company is prepared to include. It almost certainly will not act as carrot to enhance the quality of the Business Review.

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

Rating and ranking annual report narrative in an independent, authoritative and objective manner, as FutureValue does, can have a powerful effect. We are making good progress in establishing what we do as a standard, a measure and a valued rating of recognised standing. But, it is taking time.

Recognising and making awards to the very best narratives as The Strategic Planning Society does in its 'Strategic Value in Corporate Reporting Awards', or as PWC does with its 'Building Public Trust' awards, are initiatives that encourage higher standards.

The best non-regulatory solution is to validate the FutureValue finding that better narrative reporting leads to better market performance and value creation. If Directors think their stock options will be worth more due to better reporting, then most will surely make the effort to improve the quality of their reporting narratives.

DIRECTORS' REMUNERATION REPORT

Question 14: Do the current disclosure requirements provide clear and usable information about:

- **the total remuneration paid to directors, and how this is made up;**
- **the performance criteria for payments to directors, and how these relate to the company's strategic objectives;**
- **company performance against these criteria, so that there is a demonstrable link between pay and performance;**
- **the process by which directors' remuneration is decided?**

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

The information is fairly clear in most Remuneration Reports on total remuneration paid and on the process by which Directors' remuneration is decided. Few companies elaborate on the performance criteria for short-term bonuses or long-term incentives and how these relate to strategic objectives. Quite often it seems this is because many companies do not publish strategic objectives other than purely financial ones. Benchmarked Total Shareholder Return is the closest most get to a strategic measure and this is an outcome not a business objective.

COSTS

Question 15:
If you can provide any information on costs associated either with the existing narrative reporting requirements eg preparing your business review or your views on potential costs and benefits in relation to any of the ideas in this consultation, please give details

The benefits to companies of enhancing their narrative and getting the underlying content right are incalculable. FutureValue observes first hand how companies that want to improve their narrative reporting also realise that this has implications for positive change in the business – FutureValue can provide a case study on this if required. Better narrative reporting that adds strategic value should lead to positive short-term stock market performance or at least to medium-term value creation. The benefits will far outweigh the costs of enhancing narrative reporting.

FutureValue would be pleased to make available its Strategic Value Analysis technique more widely as a positive measure of what Companies can achieve. Our FTSE100 clients consider what we do to be authoritative, independent and objective. As a small research firm it may take too long for this service to become the de facto standard. The cost of helping to develop this would be quite low. In the same vein the Strategic Planning Society, an educational charity whose mission is to champion the

development of strategy as a management science, would be pleased to stage its annual 'Strategic Value in Corporate Reporting' on a bigger stage and to a larger fanfare for the winners. Again, the cost of supporting this will be relatively low. This is something the major accounting firms cannot do due to a conflict of interest vis a vis their audit clients.