



the inside track #23

Highlighting CSR and narrative reporting issues of the moment

Where next for narrative reporting?

Narrative reporting had a shake up in the past twelve months. Previously, practitioners' focus was reporting against s417 of the Companies Act 2006. This details Business Review reporting requirements and whilst some companies still faced compliance challenges, most were familiar with them, and were improving reporting quality.

Then, last summer, the advent of the UK Corporate Governance Code introduced additional governance requirements. These came into force for all listed companies for financial years starting after 29th June 2010 - so is now fully applicable. Whilst the Code is "voluntary" and acts as guidance, in reality both institutional investors and external auditors treat it as having regulatory status (although companies can "work towards meeting its principles"). A comparable example from a past Code is Board Performance Evaluation, which began to be accepted as a requirement once investors started questioning those companies not undertaking such evaluation, and then the external auditors began to recommend it as necessary.

The new Code introduced two significant changes that built upon a new director's duty "to promote the success of the company ...over the longer term", introduced in the Companies Act 2006. These changes included an explanation of the basis on which the company generates or preserves value over the longer term (the business model and the strategy for delivering the objectives of the company). It also recommended that all incentive schemes, (including share option schemes) should be subject to challenging performance criteria, including non-financial performance metrics (NFM) where appropriate. Both relate to narrative reporting.

At around the same time, the new UK coalition government's manifesto introduced a commitment to reintroduce the Operating and Financial Review (OFR) - something that came out of the blue for most observers.

That commitment resulted in a consultation exercise, led by the Department for Business, Innovation and Skills (BIS), whose response suggested future deliberations when published in the early months of 2011.

At the same time as this response, the EU published its consultation into non financial reporting. This included questions about whether there is a need to require companies to report on social and environmental matters (along the comply or explain basis), as well as whether more emphasis is required on human rights and bribery and corruption reporting, and whether there should be external auditing/verification of CSR reporting within companies' reports.

This consultation is likely to see a paper for further consultation come out in the late autumn. The Eurozone financial crisis may delay the timing, as the EU's experience of the crisis will highlight the difficulties of introducing a "one size fits all" CSR policy across states with very divergent economic circumstances.

The UK government decided to bring out two further consultation exercises. The first by DEFRA was its much awaited deliberation on mandatory green house gas reporting, as required under the Climate Change Act of 2008. The second, but still to be introduced, is BIS's follow up consultation on narrative reporting, which moves on from the OFR and aims to simplify company reporting (including acknowledging companies have websites on which to store financial information, as well as focusing the Annual Report and Accounts (ARA) on the business model and business strategy). The BIS consultation (originally planned for mid July) is now likely after the political conference season. It may be possible that there will be joined up thinking with BIS incorporating the DEFRA proposals - maybe!

And lastly, the International Integrated Reporting Committee is introducing its Integrated Reporting pilot programme this autumn, which has an objective to further develop narrative reporting.

TVC comment overleaf >



the virtuous circle comment: #23

So much discussion about change - in such a short time!

The Virtuous Circle's (TVC) recent research - "*Telling the strategic story - Narrative reporting and the use of non financial metrics in 2010 annual report and accounts*" (accessible via TVC's website http://www.thevirtuouscircle.co.uk/RESEARCH_REPORTS.html) focused on the extent to which companies anticipated the UK Corporate Governance Code guidance in their narrative reports.

Key research findings focused on two areas - business models, strategy & risks; and the use of non financial KPIs in executive remuneration policies.

The research found confusion between a business model and a business strategy, with often business strategy stated as the business model.

For the research, TVC defined **the business model** as "*How a company creates value for its shareholders TODAY*" and the **business strategy** as "*How a company plans to make more money or change its business direction FOR THE FUTURE*". Mostly, the business strategy reinforces the current business model, but with a sufficiently radical strategy, the business model may change over time.

Only half of companies analysed included a business model and there was a considerable variation in the quality of business model statements. It is important to recognise that it is acceptable to have more than one business model if there are different operational styles. As an example, Aggreko, with two marketplaces - local and international - offers two business models.

Whilst more companies reported on strategy than included business model statements, few expanded the strategy into divisional reviews. This potential lack of consistency leads to a possible interpretation that strategic implementation is left to head office, with little implementation divisionally.

It is important to emphasise that the Financial Review is part of narrative reporting. As such the business model should include the financial management aspects relevant to that business, such as capital, treasury and foreign exchange management. There were few instances where the Financial Review was written as an integrated approach to the business model (i.e. integrating financial and non-financial - *not the IIRC Integrated Report*), although Standard Life does include its business model within its Financial Review.

The extent to which risks reported in the ARA relate to the business model and strategic implementation is questionable, with a preponderance of "predictable" risk lists, and less focus on operational or strategic risks.

The research also found that where companies reported NFM as KPIs, there was often little linkage to the strategy/business model. Some NFM reported seemed to meet legislative requirements, rather than demonstrate the company's ability to achieve long term performance success.

Using NFM as annual bonus criteria for executive remuneration policies is quite high amongst larger companies (about two thirds do so) but less so for smaller companies (around a quarter). However, using NFM as criteria for long term incentives is much less frequent. Several companies promised to include NFM as criteria for executive remuneration policies in 2012.

That companies are only gradually becoming familiar with implications of this latest regulatory guidance is clear from this research. Companies (in particular the smaller ones) need guidance to help describe business models and identify business drivers, leading to the selection of appropriate NFM as KPIs. This could also cover selecting appropriate non financial metrics for remuneration policies. To reflect directors' duty "to promote the success of the company", ideally, NFM criteria for incentive plans should be longer term lead indicators.

What the research also highlights is that companies take time to adjust to new practices, and too much (or too rapid) change may not have the desired effect, unless the change builds on previous practices. Perhaps BIS should hold back until it is certain current requirements are well embedded.

If you are facing challenges regarding developing your business model and selecting non financial KPIs, and would like an objective and impartial view, contact **Tony Hoskins** - thoskins@thevirtuouscircle.co.uk - or **Ian Redington** - iredington@thevirtuouscircle.co.uk