The Future of Narrative Reporting

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Note – Pensions Investment Research Consultants Limited is a corporate governance consultancy and also Research and Engagement Partner to the Local Authority Pension Fund Forum. LAPFF is a voluntary association of 39 public sector pension funds in the UK that exists to promote the investment interests of LAPFs and maximise their influence as shareholders to promote CSR and high standards of corporate governance amongst investee companies.

Introduction

On 3 May 2006 the government announced its response to the recent consultation on mandatory narrative reporting.i In one important respect the requirements for quoted companies have been brought back to something more akin to the formerly mandatory Operating and Financial Review (OFR). While given much less media attention than other aspects of its overhaul of company law, notably the government's change of heart on the adoption of a 'safe harbour' provision, the restoration of an explicit forward-looking aspect to narrative reporting is of potentially long term significance.ii This is particularly so when account is also taken of the restoration of requirements in the original OFR relating to non-financial information, including social and community issues that had been left out of the Business Review, and information about related company policies and the effectiveness of those policies.

This article will focus on the future of narrative reporting for UK listed companies which produce a Business Review, as required by the EU Accounts Modernisation Directive, and may also publish a voluntary OFR. Whereas the government has confirmed that there will be no statutory reporting standard for the Business Review the Accounting Standards Board Reporting Statement (ASB RS) does provide authoritative guidance for the OFR.iii LAPFF and PIRC are calling on listed companies to report explicitly against ASB RS.iv

Should Companies Continue to Prepare OFRs?

The answer to this question is affected by the government's statement of 3 May 2006.

PIRC, which was strongly supportive of the statutory OFR, had developed a dual strategy to analyse mandatory Business Reviews and voluntary OFRs. The first part is concerned with assessing the sufficiency of directors' disclosure against our interpretation of the ASB RS. This will cover all FTSE companies from 1 August

2006 by means of a separate OFR/Business Review section within PIRC's Governance Plus reports. The second part focuses on companies' forward-looking information and assesses directors' predictions against their own criteria for judging subsequent outcomes year-by-year. This will cover only a small selection of FTSE 350 companies as a basis for possible engagement. The dual strategy is based on assurance and predictive models respectively.

A key problem with the Business Review, which the government has now rectified, was that it did not contain any explicit reference to forward-looking reporting as far as the minimum requirements of the EU Accounts Modernisation Directive were concerned.v As the LAPFF and PIRC submissions to the DTI consultation pointed out this stood at odds with the government's own strong commitment to forward-looking narrative reporting. The government statement of 3 May restores a key part of the original OFR objective, as LAPFF/PIRC had argued for, to require information to the extent necessary on 'the main trends and factors likely to affect the future development, performance and position of the company's business' to be included in the Business Review.vi

Without this crucial addition and the concomitant enhancement of information on non-financial matters, referred to previously, the prospects for encouraging meaningful narrative reporting would have become dim indeed. Since companies that opt for meeting only the minimum requirements of a mandatory Business Review cannot now opt out of making forward-looking statements 'to the extent necessary' those companies which aim to achieve best practice as set out in the ASB guidance by means of a voluntary OFR will not be put at a disadvantage. On the contrary it is the listed companies whose Business Reviews contain material omissions in this respect that may expect from 2007, if not in this transitional year of uncertainty, to face serious questions from investors.

In short, the case for preparing (voluntary) OFRs is based on the ability of forward-thinking companies to demonstrate over time their understanding of the business environments in which they operate. This, in turn, requires taking all relevant factors into account to the extent necessary including issues of corporate responsibility. No reasonable investor is going to expect precise predictions in areas of genuine uncertainty or criticise companies for forecasts that prove wrong over time if they were based on fair and pre-stated assumptions underlying the main trends and factors. However, companies that make no forward-looking statements or fail to set out the basis on which such information is provided, as the minimalist approach in the Business Review would have encouraged, are either demonstrating their lack of understanding of the environment in which they operate or their unwillingness to disclose to investors the information needed to assess a listed company's future success.

What Should Be Left Out from the Full Best Practice in the RS?

The ASB RS itself underlines that its disclosure framework:

'… is not a template,… 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… 'vii

In short, directors should leave out what is not relevant to their situation.

What are the Advantages and Disadvantages of Restricting Narrative Reporting?

The disadvantages of keeping to the minimum required by the revised Business Review provisions have already been alluded to: the risk of material omissions leading to more questions from investors; and directors either showing a lack of understanding of their businesses or failing to meet the statutory purpose of the Business Review, i.e. to disclose information required by investors to help assess how the directors have performed their duty to promote the success of the company.viii

One key advantage of the Business Review over a voluntary OFR, for those who trust in its protection, is that the proposed safe harbour provisions may not cover the latter.ix This will be a persuasive argument for those who favoured such protection before but not to those, like LAPFF and PIRC, who agreed with the government's earlier view that it would be impractical and inappropriate.x That remains our view – time will tell.

References

[i] . 'New Clauses to Keep Company Law Reform "Light Touch"', DTI Press Release (3 May 2006).
[ii] . See, for instance, the lead story by Jean Eaglesham and Barney Jopson, 'Companies Win Lawsuit Protection in Shake-Up', Financial Times (4 May 2006), p.1.
[iii] . Accounting Standards Board, Reporting Statement: Operating and Financial Review (ASB, January 2006).
[iv] The Chair of LAPFF wrote to all FTSE Chairman on 24 April 2006 asking them 'to commit to reporting against the ASB Reporting Statement and acknowledge this publicly in your OFR or Business Review.'
[v] . Although the Companies Act 1985, Schedule 7, paragraph 6 requires the directors' report to contain 'an indication of likely future developments in the business of the company' this has not previously led to much by way of forward-looking statements and was unlikely, on its own, to do so now.
[vi] . See note 1. Cf. LAPFF, 'DTI Consultation on Mandatory Narrative Business Reporting' Response by LAPFF (24 March 2006), pp. 1 and 4.
[vii] . ASB Reporting Statement, paragraph 26.
[viii] . 'The Business Review and Director Liability for Narrative Reporting: The Latest' Allen & Overy Bulletin (May 2006), pp. 1-3.
[ix] . See, for example, note 8.
[x] . DTI, Draft Regulations on the Operating and Financial Review and Directors' Report: A Consultative Document (DTI, May 2004), paragraph 4.10.