



9 December 2011

Our ref: ICAEW Rep 117/11

Mark Jackson  
Business Environment  
Department for Business, Innovation and Skills  
1 Victoria Street  
London SW1H 0ET

Dear Mark

**The Future of Narrative Reporting: Consulting on a new reporting framework**

ICAEW is pleased to respond to your request for comments on *The Future of Narrative Reporting: Consulting on a new reporting framework*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

John Boulton ACA  
Corporate Reporting Manager, Financial Reporting Faculty

T +44 (0)20 7920 8642  
E [john.boulton@icaew.com](mailto:john.boulton@icaew.com)



## ICAEW REPRESENTATION

### THE FUTURE OF NARRATIVE REPORTING: CONSULTING ON A NEW REPORTING FRAMEWORK

Memorandum of comment submitted in November 2011 by ICAEW, in response to BIS consultation paper *The Future of Narrative Reporting: Consulting on a new reporting framework* published in September 2011.

Contents	Paragraph
Introduction	1
Who we are	2
Major points	5
Responses to specific questions	14

## INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the consultation paper *The Future of Narrative Reporting: Consulting on a new reporting framework* published by BIS on 19 September 2011.

## WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter which obliges us to work in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 136,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.
3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.
4. The Financial Reporting Faculty is recognised internationally as a leading authority on financial reporting. The Faculty's Financial Reporting Committee is responsible for formulating ICAEW policy on financial reporting issues, and makes submissions to standard setters and other external bodies. The faculty also provides an extensive range of services to its members, providing practical assistance in dealing with common financial reporting problems.

## MAJOR POINTS

### **A welcome initiative to examine the presentation of narrative information**

5. We believe that much can be gained from a re-examination of the way in which information is presented in narrative reports; disclosure requirements have accreted over time and arguably the annual report could be seen as inflexible and compliance-driven as well as cluttered. In particular, we welcome those areas where BIS has embraced proposals from our previous response (ICAEW 109/10). In that response we set out that the annual report should form a coherent stand-alone document that clearly articulates a consistent narrative demonstrating how the business achieves success in the long term, on behalf of its shareholders, as currently required in the law. Such a narrative would combine both financial and non-financial information in the most effective way to convey its message. It would be produced with a view to providing useful information to shareholders.
6. Therefore we find much to support in the concept of a discrete strategic report. Limiting this report to a summary of the strategic issues is likely to increase clarity and relevance and therefore improve quality of company reporting. By allowing the presentation of more detailed information in a separate report, additional messages could there be addressed more coherently and in greater depth. We warmly welcome the concept of a self-contained narrative report focussed on strategic issues.

### **We are opposed in principle to the annual report being used as a repository for disclosures designed to meet regulatory objectives.**

7. We are however concerned that some of the non-financial information currently required or commonly suggested for inclusion in the annual report is ancillary to the purpose of providing useful information to shareholders. Squeezing information that is potentially less relevant into the annual report reduces its clarity and can deprive the information of the focus and attention it deserves. It may sometimes be convenient to attempt to address regulatory issues through annual report disclosures, but where this information is not relevant to an understanding of

strategic matters, and particularly where it is immaterial, it does not provide useful information to the primary users of the financial statements.

8. Therefore, unfortunately, while the concepts underlying the paper are laudable, some of its detailed proposals could put us at risk of moving backwards. For example, while embracing the principle of a strategic report, unbound by regulatory prescription and therefore versatile enough to be able to reflect different situations, in some places the paper then proposes regulatory stipulation by specifying items that are required to be included in the strategic report, albeit in some cases only 'to the extent necessary'. Genuinely strategic information helps users understand how a business intends to grow; how it will retain and increase its profitability/cash flows and thereby service its indebtedness. It could also, where relevant, reveal its attitude towards acquisitions, particularly to the extent that these could increase its indebtedness. Strategy and attitudes toward risk and its mitigation is also important. Management succession plans could usefully be discussed too. A financial institution might comment more specifically on its funding, and any risks related to this, and on how it might increase its capital base.
9. The point is that each company faces its own specific circumstances and therefore it is essential that sufficient latitude is allowed so items of importance to that company can be appropriately discussed without being obscured by others of less relevance. We appreciate that in the initial form of the strategic report these concerns are limited as they relate to only three mandated disclosures, on gender diversity, human rights issues and executive remuneration. But while all of these issues have the potential to be of strategic importance, they may well not be. Requiring or expecting their disclosure establishes a precedent that the strategic report could potentially be used in future as a repository for items that may not be strategic. We think that this is a shame given the attractive potential and relevance to investors of this new report. As well as these mandated items, other environmental and social matters are also required to be disclosed 'to the extent necessary'. If such a formulation is used, in our opinion it should not be accompanied by a requirement to state that no disclosures have been made on these subjects, as is presently the case in CA 2006 s 417(5). This requirement gives an erroneous inference that the company considers that anything it might say on the specific subject is insignificant when in fact it may be important but still not meet the level of significance to merit inclusion in a strategic report.
10. And the consultation also regrettably attempts to cover too much ground by exploring the issue of executive remuneration in extensive detail within a consultation ostensibly aimed at narrative reporting. These questions would have been better included within the separate, and contemporary, BIS consultation on executive remuneration. The focus of the present exercise is diluted by their inclusion.

**Financial Reporting lab is ideal environment to experiment with ways of achieving the improvements that the paper promises**

11. We are also enthusiastic supporters of the FRC's new financial reporting lab. We are conscious that to achieve the incremental improvements in narrative reporting that are the objective of the paper, further development and experimentation will be necessary. We feel that this is best achieved through peer pressure and the sharing of best practice, and believe that such a process is best conducted before final legislative changes are drafted. Therefore the Lab appears to be an ideal environment within which to complete this work.

**A proposed effective date in 2012 is too soon**

12. To implement the proposals properly companies (and users) will need more time. 2012 is not achievable and we therefore believe the effective date should be delayed by at least a year.
13. As a result of the consultation exercise it may be that important changes are made to certain areas of the proposals. As a result we would welcome their further exposure at the draft

legislation stage such that constituents may have an opportunity to express their final comments before enactment.

## RESPONSES TO SPECIFIC QUESTIONS/POINTS

### Question 1

**Do you agree in principle with restructuring the current reporting framework into a Strategic Report and an Annual Directors' Statement?**

14. Yes. In our response to the previous narrative reporting consultation (ICAEW REP 109/10) we made the suggestion that where there is a genuine demand from users for standardised regulatory disclosures, it would be best to separate these out from the company specific items currently contained in the business review - the contents of which should be bespoke to individual company circumstances. Therefore we welcome the proposal to separate out this strategic information, which should be aimed squarely at capital providers as the primary users of the financial statements, from that deemed necessary for policy purposes.

### Question 2

**Do you agree that the Strategic Report should include information on:**

- company performance
- principal risks and uncertainties
- key performance indicators
- key financial information (similar to that currently required for the Summary Financial Statements)

**and for quoted companies should include:**

- strategy,
- business model,
- environmental and social information,
- key information on executive remuneration and its link to performance?

15. We welcome the paper's conceptual separation of strategic from regulatory information and we believe that this potentially represents a welcome step forward for corporate reporting. However, we are a little disappointed that it then appears to stipulate several elements of the strategic report. Neither companies legislation nor any other regulatory source is in a position to determine what is strategically important for an individual company; only the directors can make this assessment. It should be recognised that narrative reports differ from other information in the financial statements in that their form and content is much more variable based upon the circumstances of the company and the judgments made by management. Indeed the value of narrative information is directly derived from its bespoke nature. Whereas financial information may benefit from being communicated in a standardised format (for example the familiar fixed assets table), such standardisation in narrative reporting invariably results in 'boiler-plate' disclosures of little value for users. It could even be more onerous; a rigidly imposed form may cause companies with multiple listings to have to produce a special strategic report just to meet UK requirements. Duplication could also occur between the contents of the strategic report and the annual directors' statement.
16. We believe that given the bespoke nature of these disclosures best practice and peer pressure are much more effective in driving up standards than imposing a potentially rigid framework. For this reason we warmly welcome the FRC's instigation of the Financial Reporting lab, a promising environment within which to foster innovation and the sharing of best practice before new requirements are embedded in law. It would be preferable for the contents of the strategic report to be fine-tuned through this medium rather than certain elements being already laid-down in advance. In some cases information about executive remuneration, gender diversity or human rights policy will be essential to understanding a company's position or performance. In these cases such disclosures would in any case be expected in order to understand performance or principal risks or uncertainties. But in other cases it will not have such relevance. We would therefore disagree that these three items should specifically be

mandated for inclusion in the strategic report regardless of their significance. We are particularly concerned that inclusion of these three items at this early stage could be seen as a precedent for further such requirements to be inserted over time; this would be most unwelcome.

17. If it is felt necessary to include a requirement for disclosure around issues such as social, environmental or governance matters it would be better for this to be drafted in broad terms so that companies can disclose items of particular relevance to them. For example, rather than disclosing the ratio of female board members a more general requirement to disclose relevant diversity policies, 'to the extent necessary', could be included. In some cases this may well take the form of gender diversity ratios but in other cases different KPIs may be relevant – for example a company with significant South African operations may choose to report on its progress against Black Economic Empowerment objectives. In other cases KPIs in these, or other, suggested areas may not be relevant at all and therefore they should not be expected to be disclosed. However, we believe that where the 'to the extent necessary' formulation is used, it should not be accompanied by a requirement to state that no disclosures have been made on these subjects, as is presently the case in CA 2006 s 417(5). This requirement gives an erroneous inference that the company considers that anything it might say on the specific subject is insignificant when in fact it may be important but does not meet the level of significance for inclusion within a strategic report.

### Question 3

**Do you agree that the proposed Strategic Report should replace the Summary Financial Statements?**

18. Not necessarily. Although companies may wish to make use of the strategic report in combination with their summary financial statements we do not believe that any legislation in this area should be based upon an assumption that the two reports are interchangeable. Therefore, further research in this area to determine the needs of users would be welcome. Before any further decisions are taken it would certainly be useful to put together sample versions of the summary financial statements and strategic review, and through discussions with users then determine where and by how much the two should overlap. To the extent that the strategic report does not necessarily include information on directors' remuneration it is likely that this element will be considered an essential 'add-on' module in summary financial statements. The Financial Reporting Lab may be a good mechanism for conducting this research. This would allow any difficulties or inefficiencies to be more easily resolved and would enable experimentation on whether certain parts of the summary financial statements legislative requirements should be retained in a form such that they can be added into the strategic report.

### Question 4

**Do you agree that the Strategic Report should be signed off by each director individually?**

19. We strongly disagree with this suggestion and question the value of such a move given that the current requirements as to board approval are quite adequate to represent the Board's responsibility for the financial statements. This fundamentally undermines the principle of collective board responsibility and seems to be based on the erroneous premise that the directors take their current responsibilities for disclosure lightly. We have seen no evidence that this is the case, nor is any provided in the paper.

### Question 5

**Do you agree that the Annual Directors' Statement for quoted companies should include:**

- disclosures required, regardless of materiality, by the Companies Act, the Listing Rules etc.
- the Corporate Governance Statement
- the Directors Remuneration Report
- financial information (for example, post-balance sheet events etc)

- **information provided voluntarily by companies (for example, additional environmental and social disclosures)?**

**20.** We agree that in principle the Annual Directors' Statement could be a useful reference document and we warmly welcome moves to separate out this more generic data from the highly bespoke contents of the strategic report. However, we would note that the purpose of publishing the annual report and financial statements is ultimately to meet the information needs of shareholders and investors rather than to fulfil other regulatory objectives. Regulators often have the statutory power to obtain the information they require by other means and therefore the annual report is not the appropriate place for meeting these demands. In addition, disclosures that are imposed on companies to meet other policy objectives should be dealt with through an alternative route; we deplore the tendency to see disclosure as the immediate answer to all policy issues and in particular the use of the annual report as a dumping ground for such disclosures. We also disagree in principle with the concept that it is desirable to create a repository for disclosures 'required regardless of materiality'. If the items to be included are immaterial they will by definition not be of interest to shareholders or investors (and may not be useful to other stakeholders either). A more useful question may be to ask whether it is necessary to disclose such items at all; if it is, governments and regulators should consider alternative vehicles for disclosure outside the annual report.

#### **Question 6**

**Do you agree that companies should be able to include material in the Annual Directors' Report (for example information on policies and procedures) by cross reference to information published elsewhere (for example on the company's website)?**

**21.** We welcome efforts to integrate reporting requirements more effectively with available technology and developments in how this is used and we are therefore encouraged that this appears to be a guiding principle behind the paper. We noted in ICAEW REP 109/10 that electronic publishing offers interesting new possibilities for the presentation of company information and we are enthusiastic about the opportunities the internet offers for the publication of the annual report. However, a note of caution should be sounded here: the strategic report and the annual directors' statements are both discrete, point in time documents. It is essential that the information they include is controlled and retrievable in some form such that necessary data remains accessible for an appropriate time period after publication. The boundaries for board approval, standards (including the true and fair requirement), safe harbours and audit or assurance of information also need to be clearly established. Therefore, although we are enthusiastic about the opportunities to improve the depth and timeliness in this way, we do feel that any such links would need to be carefully managed such that what comprises the statutory reports can still be held to show a true and fair view. And at least an archive version of the intact document in its intended form will need to be retained for reference.

#### **Question 7**

**If companies are able to include material in the Annual Directors' Statement by cross reference (question 6), do you agree that they should make an annual statement confirming it has reviewed that information and noting any significant changes?**

**22.** Greater clarity is needed on this point. As we note in paragraph 20 above, significant questions about the boundaries of the document need further consideration. However, even assuming that cross-referenced data is to fall outside of the statutory report, the relevance and understandability of the annual directors' statement could still be affected by the data to which it is linked. Question 7 makes significant assumptions about the permanence of website data and these may be inappropriate. The internet is a medium where rapid change is common and many webpages change regularly, even multiple times in a day. To include in this context information that is intended to remain fixed from one year to the next introduces significant new risks; conversely, requiring information to remain static for regulatory purposes may reduce its usefulness and the flexibility that web-based delivery can bring. In our view these structuring issues in relation to the various parts of the package and the different channels through which they might be delivered, are undeveloped in this paper.

- 23.** We appreciate the flexibility that electronic cross-referencing can bring and acknowledge that this has the potential to enhance reporting, but it needs to be carefully managed. In substance this proposal does appear to pre-suppose that through the mechanism of statutory reporting requirements an incremental level of control can be imposed on certain sections of company websites. This is likely to be problematic in practice, could ultimately amount to another regulatory burden on business and may be unnecessary to achieving the narrative reporting requirements the paper seeks. Admittedly some controls do already exist in this area, requiring for example the maintenance of a website in the first place for listed companies and that certain information be published. But these requirements work within the bespoke framework of a company's own website. The more prescriptive they become the more difficult it is to reconcile the regulation with the daily operational business of maintaining a website.
- 24.** Companies are also likely to have significant concerns about the volume of data that could potentially become linked, directly or indirectly, to the directors' statement through cross-references to the website, even if this does not formally form part of the statutory report. This could then lead to the volume of data available being limited in consequence, which would not be useful to stakeholders. An opposite risk is that by increasing the quantity of data its quality is reduced – it may be easy for such a collection of data to degenerate into little more than a marketing document. The annual report has traditionally been more than this, and may indeed be the only public document that is prepared with a view to this careful balance, and it would be a pity if this was lost. In short, this area needs further thought and more clearly articulated proposals before it is taken any further.

#### Question 8

**Do you agree that the Annual Directors' Statement should be presented online with a hard copy available to shareholders only on request?**

- 25.** This question would appear to be largely redundant as many companies have already taken the present option of only providing hard copies of the annual report on request. However, we would note that most private companies will not have a website and if they do it may be relatively unsophisticated. They may also have only a few shareholders. In such cases it could be more onerous for them to publish electronically than simply providing a hard-copy and therefore we feel that that electronic publication should be optional. In any case an electronic copy will be available from Companies House for those who wish to access it. Furthermore, we note that the question references only the annual directors' statement. If requesting a hard copy document most users would expect to receive both the strategic report and the annual directors' statement as well as the financial statements.

#### Question 9

**Do you support removal of the disclosure requirements arising from company law identified in Table 1? If not, please provide evidence of their relevance to users, including why disclosure in the Annual Directors' Statement is necessary for meeting their needs. Are there any other disclosure requirements arising from company law that in your view could be simplified or removed?**

- 26.** We warmly welcome BIS's initiative to simplify company reporting by removing regulatory measures that are potentially unnecessary and we agree that the removal of most of the disclosures listed in table 1 would result in a useful simplification for many companies. In particular we believe that in practice the disclosures about employee involvement and creditor payment have not been effective in achieving the policy objectives they were originally included to meet. Commonly responded to with boiler plate disclosures, typically these disclosures add little value. Indeed these items illustrate the potential futility of attempting to meet policy objectives through disclosure in the annual report, as noted in paragraph 17 above.
- 27.** We do see this list only as a starting point and we encourage BIS to establish a more comprehensive exercise in identifying redundant requirements from whatever source, with



criteria established for judging that question. Where these are not within the remit of the UK (because they derive from EU law, for example), then the UK government should lobby for their removal.

- 28.** We would suggest, however, that the disclosure of charitable donations be maintained. Where these are significant it is likely that investors will be interested in this information; as with political donations, these represent non-reciprocal payments that may have no primary business purpose, from funds that would otherwise be available to shareholders and for which directors ought to be accountable. However, the current limit of £2,000 is unlikely to be relevant for economic decision-making by any of the parties involved and therefore we suggest that this is increased somewhat: perhaps £10,000 would be more appropriate.

#### Question 10

**Are there areas where the Listing Rules, IFRS, company law and the Corporate Governance Code are inconsistent or require similar disclosures? If so, how could these best be resolved?**

- 29.** We note that there are some overlaps between the Companies Act and the listing rules relating to Directors' remuneration. As an example; some related party disclosures such as contracts with controlling shareholder are anyway caught by IAS 24 Related Party Disclosures. Off balance sheet arrangements and disclosures on financial risk management objectives and policies (policy for hedging and exposure to price risk, credit risk, liquidity risk and cash flow risk, etc) could also be included as these are also already requirements under IFRS. And disclosures of directors' pension benefits as required by the listing rules and company law also have some inconsistencies. To resolve these we would refer back to our point in paragraph 26 above and would urge BIS to initiate a comprehensive study as a means to identifying and resolving all such overlaps. ICAEW are currently working to identify areas of company law where simplification could potentially be achieved and will submit the results of this exercise to the Department in due course.

#### Question 11

**Should quoted companies be explicitly required to include information about human rights (to the extent necessary for an understanding of the development, performance or position of the company's business) in the Strategic Report?**

- 30.** Yes, 'to the extent' that it is relevant to an understanding of an entity's business. We are strongly supportive of ethical business practice regardless of the jurisdiction(s) within which an organisation operates and we believe that any interaction with stakeholders that does not reasonably respect their human rights is wholly reprehensible. We welcome government action to detect and curtail any such abuses. However, annual report disclosure is quite unsuited to the achievement of this type of objective. We support a requirement to disclose this information 'to the extent necessary for an understanding of the ... business', but we would be opposed to mandatory inclusion regardless of relevance. It should be noted that many listed companies make great efforts to report upon their work to ensure fair treatment of employees and other stakeholders, and we are therefore concerned that inappropriate prescription in this area could prove counter-productive.

#### Question 12

**Do you support the Government's proposals for company disclosure of the proportion of women on boards and in companies as a whole?**

- 31.** Again, we strongly support government efforts to improve female representation at the highest level in business and in the professions. Indeed we are keen advocates of wider efforts to embrace diversity across organisations; action in this area could help to positively add value. However, we feel that the current proposal is misguided; it is already a requirement to disclose the names of directors and many companies also include photos. Statistics on gender diversity are therefore already readily calculable - explicitly publishing the ratio is superfluous and risks cluttering the Strategic Report, which is not in any case the right place for such disclosures. It

would be better for a more general requirement to disclose information on diversity policies and achievements 'to the extent necessary for an understanding of the ... business'.

### Question 13

**Do you agree that the current UK liability regime does not discourage companies from making meaningful forward looking statements? If you believe that there are issues with the current regime, do these relate to:**

- companies listing in the US as well as in the UK,
- companies contemplating a prospectus,
- common misunderstandings about the UK liability regimes
- other concerns?

**32.** We have doubts about how practical it is to expect such forward looking statements. It is certainly important to understand management's current strategy and the risk environment in which they operate; these are indeed essential elements of the strategic report. But to extend this into detailed predictions of future events is likely to be largely futile. It is not possible to predict the future with any degree of accuracy, and even where such statements are limited solely to discussing management's established plans there is no certainty that these will occur as originally intended or even at all. Consequently to mix this, potentially speculative, information with carefully compiled, verifiable, statements about the present and past risks detracting from the reliability of the report. We therefore do not believe that the regulatory regime is necessarily the issue here but rather that 'meaningful forward looking statements' may be an unrealistic aspiration.

### Question 14

**Would improved understanding and awareness of the UK liability regime help encourage more meaningful, forward looking statements? Are there other activities or changes that the UK Government could make that you believe may be necessary?**

**33.** Please see our answer in paragraph 31 above. In our view, reputational risk may be more important to directors than liability. But they will more likely be constrained by avoiding discussion of actions not yet decided upon on the grounds of commercial sensitivity and simply not wishing to establish expectations that may not be fulfilled.

### Question 15

**Do you agree that the key information on remuneration should be included in the new Strategic Report? If so, would a standard format for this information be helpful?**

**34.** We do not agree; as we have set out in paragraph 12 we feel that the Strategic Report should be just that, a succinct summary of strategic level information. In some cases information about remuneration may be relevant to this, in other cases it will not be. To try to mandate its inclusion regardless of relevance is inappropriate. Moreover to appraise properly this information it is important that it be disclosed in a context where all relevant details are included. Moving a summary to an alternative location risks only showing part of the picture, which could be misleading, and also potentially creates unnecessary duplication. It is particularly important to understand which elements are cash and which are not, and such nuances may not be able to be properly communicated in a summary. Currently information about directors' remuneration is included in summary financial statements. If it is considered important for this practice to continue, then this should be incorporated in SFS requirements rather than being included in the strategic report so that that report could potentially be used as SFS

### Question 16

**Which elements of the current disclosure requirements could be moved to the Annual Director's Statement, or removed entirely?**

**35.** See our answer to Question 15. As with governance matters, we believe that remuneration information should be shown in one place - the Annual Directors' Statement; the Strategic Report is not the appropriate place for the reasons discussed above. The proposals also could

create logistical problems for the advisory vote on the remuneration report if the information is not all in the same place. It should also be noted that some listed companies are already required to comply with the disclosure requirements of the Merlin/Remuneration code; any new legislation in this area should not introduce overlap or duplication with these existing requirements.

## Section 5

- 36.** We are disappointed that a consultation on narrative reporting, which has some useful developments to explore, has been partially sidelined by the debate on executive remuneration, particularly when BIS has a concurrent consultation on that issue. We appreciate that underlying the questions in this section are some significant issues of policy. We do not attempt to tackle these themes in this response and therefore the answers that follow to questions 17 to 26 are strictly responding to the corporate reporting implications of the proposed disclosures. Our response ICAEW 111/11, submitted on 25 November 2011, explores the policy implications of executive remuneration reporting in more detail and we suggest that the responses that follow are considered in conjunction with the wider issues we raise in that letter. A copy of ICAEW 111/11 is included as an appendix to this submission.

### Question 17

**Do you agree that quoted companies should be required to disclose the total remuneration of each director in a single cumulative figure? If so, how should be calculated so that it accounts appropriately for the various elements of remuneration packages, including share options, LTIPs and pensions?**

- 37.** As set out in ICAEW REP 111/11, we support the disclosure of a total number for individual directors' remuneration provided that it is clear about what is to be disclosed and the basis to be used for valuation. The department should be under no illusion that this will be a difficult calculation to perform and clarity of disclosure around the method of calculation will be key to ensure any level of comparability.

### Question 18

**Would there be benefits in introducing a requirement to disclose the pay of the highest earning executive officers below board level and, if so, to which companies and individuals should such an obligation be extended? Are there alternative ways of improving shareholder oversight of the performance and pay of influential non-board executive officers?**

- 38.** Not necessarily. The disclosure of board remuneration is essential due to agency issues, but this consideration is unlikely to apply to employees below this level who do not have the latitude to determine their own pay and to whom the same agency issues do not apply. There may be some instances where the level of remuneration to certain non-directors is sufficiently disproportionate to be of interest to investors, for example where a director of subsidiary is paid significantly in excess of members of the main board. But in general we do question the relevance of this disclosure to investors when the directors are charged with controlling all costs, not just employee costs.

### Question 19

**Do you agree that quoted companies should be required to disclose how remuneration awarded relates to performance in the relevant financial year and to the company's strategic objectives?**

- 39.** Yes, this seems to be a reasonable requirement for the remuneration report. We would note that some companies already make laudable disclosures of this type.

### Question 20

**Should quoted companies be required to illustrate performance and the total remuneration of the CEO for the last five financial years, to enable shareholders to assess the**

**relationship between total pay and performance over time? If so, which performance measure would be the most appropriate?**

- 40.** Yes, we believe this is a positive suggestion as it is useful to understand the link between remuneration and long-term performance. However, we do question why this disclosure would be limited to the Chief Executive, other directors also have responsibilities for performance and therefore they could usefully be included as well.

#### **Question 21**

**Should quoted companies be required to explain how the performance criteria for remuneration policy for the year ahead relates to the company's strategic objectives, as set out in the new Strategic Report?**

- 41.** Useful information could be provided in this way although there is a risk that qualitative descriptions in this area may be rather generic in some cases. Disclosing forward looking quantitative information can be problematic, although this too may be achievable by, for example, providing the expectation for a range of scenarios. As we state in ICAEW REP 111/11, the proposal for companies to disclose expected remuneration in differing performance scenarios has the merit of encouraging remuneration committees to consider all potential outcomes which can only be a good innovation. The reality is that remuneration committees already consider differing performance scenarios; if shareholders believe that disclosure of these would give helpful context to their decisions, for example on the advisory vote on director pay, this should drive the requirement.

#### **Question 22**

**Should quoted companies be required to provide estimates of the total future remuneration of executive directors if they exceed, meet or do not meet their performance criteria?**

- 42.** Information about long-term incentive plans can be useful for users and indeed disclosure of this is already required. However, as we note in paragraph 30 disclosure of forward looking information is potentially problematic.

#### **Question 23**

**Should quoted companies be required to disclose the performance criteria for annual bonuses? If so, should companies be permitted to delay the publication of commercially sensitive performance criteria for up to two years?**

- 43.** In principle it is useful to understand the different elements of executive remuneration. However, we are concerned that this could result in unduly complex disclosures, particularly as bonus arrangements could differ from director to director.

#### **Question 24**

**Would disclosure by quoted companies of the ratio between the pay of the company's Chief Executive and the median earnings of the organisation's workforce provide useful information to shareholders? If so, how should the ratio be calculated?**

- 44.** We question the usefulness of such a metric as it would vary more depending upon company circumstances than upon the exact level of remuneration of the Chief Executive. Companies with significant staff numbers in low cost locations for example would have a very high ratio, the ratio could even change in some situations merely because a plant is moved from one location to another. And despite the relative levels of the ratio this may say nothing about the local appropriateness of remuneration levels offered. Therefore we do not believe this would be useful and we are concerned it could even be misleading. The difficulties of calculation should also not be underestimated, including currency issues, treatment of part-time staff and contractors, the impact of acquisitions and divestments and the replacement of the chief executive part-way through a period, to list just a few. We query the cost-benefit case for such disclosure when it is not possible to see any use to which the information could be put by investors.

#### Question 25

**Do you agree that quoted companies should be required to disclose the total spend on directors' remuneration as a proportion of profit for the relevant financial year?**

- 45.** No, we do not see the value of this disclosure as this metric is easily computed from data that is already published.

#### Question 26

**Should the amount of fees paid by companies to remuneration consultants be disclosed, and is there any further information which should be disclosed by companies in relation to the procedure for setting directors' remuneration?**

- 46.** As we set out in our response to the Executive Remuneration consultation (ICAEW REP 111/11) we support the suggestion that companies should be required to disclose fees paid to remuneration consultants. These should also include full disclosure of the services provided to both the remuneration committee and to management by the remuneration consultants as well as confirmation that no conflicts of interest exist.

#### Question 27

**Do you agree that company law and the Listing Rule disclosure requirements on remuneration should be made fully consistent?**

- 47.** Yes, we have requested this clarification for many years and would welcome action in this area. However, we would go further and would aim to eliminate all duplication, particularly by removing rules entirely if they do not widen applicability of similar rules from other sources.

#### Question 28

**Would reporting under International Financial Reporting Standards provide an appropriate basis for disclosure of remuneration in the preceding financial year if this were required on both an aggregate and individual basis?**

- 48.** The relevant IFRSs in this area calculate the value of certain benefits received on the basis of long-term mathematical models. The outputs of these, which are then used to supply the amounts recognised in the IFRS profit or loss account may not equate to the actual value accruing to employees in the year of vesting and therefore there are likely to be some differences of measurement between the Companies Act disclosures and remuneration calculated for IFRS purposes. Therefore there may be difficulties in reconciling between the two. However in principle we would support the disaggregation of the IFRS 'key management' remuneration disclosure to show the components of this relating to statutory directors.

#### Question 29

**Do you agree that the current legislative regime for audit and assurance for narrative reporting is adequate for your needs? If you support assurance beyond the consistency of the Strategic Report and the Annual Directors' Statement with the accounts, then please explain what you believe assurance should be provided on and the benefits that you believe will ensue.**

- 49.** Yes, we believe that the current requirements are adequate. Where there is a demand for greater assurance this is likely to be apparent from market demand. In the absence of an apparent need from users, which in any case would encourage companies voluntarily to conduct a more rigorous assurance exercise, we do not support extending the scope of statutory audit in general.

#### Question 30

**Are there any actions that the Government could take to make the process of obtaining additional assurance on specific information in company narrative reports easier or less costly?**

- 50.** If company narrative reports were to be included in a separate document, it may perhaps be easier to devise an assurance report, tailored to that specific information, without the risk of

reducing the value of information by making it generic and boilerplate. We support allowing investor-driven innovation in this area and we therefore support a voluntary rather than a statutory approach to this type of reporting. In our view the profession, rather than regulators, should take the lead in developing appropriate services to meet the needs of users through discussion with relevant stakeholders. We would also encourage this point to be linked to the agenda of the Financial Reporting Lab hosted by the FRC.

### Question 31

**Do you agree that the Audit Committee Report should contain, in addition to existing requirements:**

- **How long the current auditor has been in post; and when a tender was last conducted.**
  - **The length of time since the directors, including members of the audit committee, have held discussions with principal shareholders about the company's relationship with its auditors, including the quality of service provided?**
- 51.** We have been generally supportive of greater transparency over the activities of the Audit Committees and agree that these may be useful disclosures; indeed the first of these is already included within the FRC Guidance for Audit Committees. Including this in the UK Corporate Governance Code itself could improve compliance. We would suggest that it be extended to say "... and, if no tender has been conducted in the last [x] years, the Report should explain why the Audit Committee is satisfied as to the quality and independence of the auditor such that a tender is not required". The second disclosure seems to be slightly circuitous. It would be more informative to require "The outcome of any discussions between the audit committee and major shareholders about the company's relationship with its auditors, including the quality of service provided, and where such discussions have not been undertaken for [x] years, the reasons why such discussions have not been held." We note, however, that the European Commission is about to propose a Regulation in this area and we suggest that, while working to influence the direction of travel in Brussels, any changes in this area await that Regulation to avoid two different but competing sets of audit committee disclosure.

### Question 32

**The Government would also welcome views on the impact of these proposals, both on the cost of preparation of the Audit Committee Report, and of the benefits to investors of having access to this information.**

- 52.** We believe such disclosure may provide investors with useful information around the quality of the audit and independence of the auditors and should be relatively inexpensive to prepare.

### Question 33

**What guidance should be provided for preparers of the Strategic Report and the Annual Directors Statement? For example, what form should the guidance take (case studies, best practice, minimum compliance requirements), how should it be disseminated and should it be high-level and principles-based or more detailed and specific?**

- 53.** We believe that the principles for the contents of the strategic report should be issued in the form of best practice guidance. We do not believe that mandation can be effective for narrative reporting, where factors affecting the business and its operating environment are bespoke to its specific circumstances. With the FRC Financial Reporting lab now having been established there is an ideal environment for the development and dissemination of best practice and therefore we suggest that this would be an appropriate mechanism within which to move the proposals forward.

**Question 34**

**Do you agree with the Government's proposal that the reporting statement and supporting guidance should remain voluntary? If you support a mandatory statement, please explain why that is necessary for your requirements.**

**54.** Yes, we agree. Narrative reporting lends itself better to voluntary guidance than a more prescriptive approach.

**Question 35**

**Do you agree that understanding of the profile and working practices of the FRRP should be enhanced, but that the remit of the FRRP should remain unchanged?**

**55.** We believe that the FRRP has worked well since its inception as an effective mechanism to drive up standards and therefore we do not see any reason to significantly alter its remit at this time. Nevertheless we would note that it is important for the enforcement mechanism to avoid becoming excessively dogmatic. Narrative reporting, and particularly risk assessment is an inherently subjective area and we do not believe it is constructive to see companies being unduly penalised because their judgments do not accord with those of other commentators on the accounts. If the regime were to develop in this way there is a risk that disclosures could either become generic and of little use to users or even be curtailed. This would be a retrograde step. We do not believe that further action to enhance understanding of the profile or working practices of the FRRP is necessary.

**E**     [john.boulton@icaew.com](mailto:john.boulton@icaew.com)

Copyright © ICAEW 2011  
All rights reserved.

This document may be reproduced without specific permission, in whole or part, free of charge and in any format or medium, subject to the conditions that:

- it is appropriately attributed, replicated accurately and is not used in a misleading context;
- the source of the extract or document is acknowledged and the reference number 117/11 is quoted.

Where third-party copyright material has been identified application for permission must be made to the copyright holder.

[icaew.com](http://icaew.com)

# APPENDIX



25 November 2011

Our ref: ICAEW Rep 111/11

Executive Pay Discussion Paper  
Business Environment  
Department of Business, Innovation and Skills  
1 Victoria Street  
London  
SW1H 0ET

By email: [executivepaydiscussionpaper@bis.gsi.gov.uk](mailto:executivepaydiscussionpaper@bis.gsi.gov.uk)

Dear Sirs

## **Executive Remuneration Discussion Paper**

ICAEW welcomes the opportunity to comment on the discussion paper *Executive Remuneration* published by the Department for Business Innovation & Skills (BIS) on 19 September 2011, a copy of which is available from this [link](#).

ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter which obliges us to work in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 136,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

This response reflects consultation with the ICAEW Corporate Governance Committee which includes representatives from the business and investment communities. The Committee is responsible for ICAEW policy on corporate governance issues and related submissions to regulators and other external bodies.

Some of the ground covered in this discussion paper was covered in the call for evidence *A Long-Term Focus for Corporate Britain* published by BIS in October 2010. A copy of our response to that call for evidence, ICAEW Rep 07/11, is available from this [link](#).

Although the UK has an existing system of governance relating to executive pay which has been built up over several decades this appears not to have led to effective alignment of pay with performance in the largest of our listed companies. While this is deeply worrying in governance terms we believe that it is essential to support positions taken in any discussion paper with sufficient factual and research-based material to ensure that any new initiatives in this area are built on firm foundations.



As executives operate in a global market it is difficult to view this as simply a UK issue that can be tackled by increasing UK regulation or making changes to existing UK governance frameworks.

We have set out observations in more detail in the appendix to this letter.

Yours sincerely

**Robert Hodgkinson**  
**Executive Director, Technical**

**T** +44 (0) 28 7920 8492

**E** [robert.hodkinson@icaew.com](mailto:robert.hodkinson@icaew.com)

## APPENDIX

### The growth in pay

1. We agree that the growth in pay cannot be linked to definitive causes and that increasing trends in executive remuneration are likely to result from a combination of factors, some local and some global, none of which appears to be dominant. We found it revealing that none of the graphs included in the discussion paper sought to demonstrate a link between pay and the rise and fall of profits in companies. This may need to be addressed in order to close any gaps in the existing evidence base before policy decisions are taken.
2. Reduced tenure and changing practices over terms and conditions of employment and pensions, including shorter notice periods for directors, may be factors in driving increases in basic and incentive remuneration. There is scope for research in looking into these areas in more detail to establish their effects on remuneration.

### Improving transparency

3. It is important that companies provide clear and accessible information about remuneration to enable shareholders to scrutinise and challenge where appropriate. However, many commentators believe that greater pay disclosure has 'ratcheted up' directors' pay and that increasing disclosure below director level may simply extend the existing problem of escalating pay levels. There is scope for research to help establish whether the benefits of increased disclosure in terms of improved performance have outweighed potential ratchet and other effects on costs.
4. The Directors' Remuneration Report Regulations introduced in 2002 and subsequently amended have undoubtedly provided a useful framework which assists users of annual reports but regulation is not and cannot be, in isolation, a substitute for good governance and best practice reporting. The link between pay and performance is still not sufficiently clear and companies and their advisors still have improvements to make in reporting on how pay is linked to absolute, rather than relative, performance.
5. Remuneration reports are already complex documents which are hard, even for those experienced in remuneration, to understand and compare. We support the disclosure of a total value for individual directors' remuneration provided that it is clear what is to be disclosed and the basis to be used for valuation.
6. The proposal for companies to disclose expected remuneration in differing performance scenarios has the merit of encouraging remuneration committees to consider all potential outcomes which can only be a good innovation. The reality is that remuneration committees already consider differing performance scenarios but disclosure of these would be helpful.
7. We support the suggestion that companies should be required to disclose fees paid to remuneration consultants and include full disclosure of the services provided to both the remuneration committee and to management by the remuneration consultants as well as confirmation that no conflicts of interest exist.

### Role of shareholders

8. We are not convinced that shareholders actually are seeking any more than an advisory vote on the remuneration report and we see no evidence that they are actively seeking direct representation on board committees. We believe that shareholders already have sufficient mechanisms to change company behaviour on pay and with an annual vote on director re-election believe that a binding vote on the whole of the remuneration report is a step too far. Shareholders already have the ability to vote down any remuneration report or intended share plans that they do not agree with. Existing shareholder powers coupled with

the Companies Act 2006, which already requires company directors to act in the long-term interests of shareholders, should be sufficient.

9. In practical terms any binding shareholder vote on prior remuneration committee determinations would be difficult to implement because of the contractual obligations already incurred and the difficulties of unwinding contractual commitments already in place.

### **Role of remuneration committees**

10. We acknowledge that in some respects remuneration committees appear not to be working correctly and that there needs to be better debate at remuneration committees. Perhaps this can be achieved through greater diversity of thinking.
11. We do not however believe that simply widening remuneration committee membership would have a significant effect on the dynamic of setting remuneration. We feel that appointing employee representatives is not the route to adopt in the UK because they would suffer from information asymmetry that would put them at an immediate disadvantage in the committee room. If the employee representative was one lone voice they may find themselves regularly outvoted and it is hard to see how they could operate being the only member of the remuneration committee not on the board. Further, would the employee representative be expected to be independent of mind and to exercise their own judgement or would their role be to reflect employee opinion? Remuneration committees could have professional members similar to some pension scheme trusts but even so it is hard to see how they could operate without understanding the context of the board's activities as a whole.
12. We do however believe that greater scrutiny of the activities of remuneration consultants and how they interact with the remuneration committee could have a significant effect on practices. This could be achieved by building on the work already done in this area by the Remuneration Consultants Group.

### **Structure of remuneration and promoting good practice**

13. Simplification of executive pay has to be the way to overcome the apparent lack of transparency in this area and prevent bad publicity. There is merit in simplicity over complexity when it comes to remuneration.
14. If the disclosure of directors' pay arrangements in annual reports was expected to be clear, this would focus the attention of boards and consultants on effective communication and the need to avoid overly complex arrangements that are impossible to communicate clearly. It might then be possible to require detailed disclosures to be made elsewhere, for example on the company's website, to meet the need for transparency.

### **Conclusion**

15. There needs to be fresh and innovative thinking when reviewing the ways in which market participants seek to incentivise boards, managers and each other to act in the interests of those that they are meant to serve. Fundamental areas that could usefully be researched are:
  - Why certain incentives have failed and are failing and how people can be incentivised to achieve longer term strategic objectives.
  - Why new mechanisms are needed to link pay to value creation.
  - How pay fits into broader issues of human capital governance.
16. There is a real need to obtain accurate and clear research in a cost-effective way. The academic community is the most obvious source for such research.