

ICAEW REP 14/06

NARRATIVE BUSINESS REPORTING

Memorandum of comment submitted in March 2006 in response to the DTI consultation paper 'Narrative business reporting. A consultation on narrative reporting requirements for companies', published in February 2006

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INTRODUCTION

1. The Institute of Chartered Accountants in England & Wales ('the Institute') welcomes the opportunity to comment on the consultation paper '*Narrative business reporting. A consultation on narrative reporting requirements for companies*', published for comment by the Department of Trade and Industry in February 2006.

WHO WE ARE

2. The Institute is the largest accountancy body in Europe, with more than 127,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.
3. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry through the Financial Reporting Council. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy.

THE OFR: LEGISLATION OR MARKET PRACTICE?

4. Over the past decade the Institute has been a persistent champion of improvements in public reporting by listed companies. We believe that a clear commentary issued alongside the annual financial statements is an important element in the communication process, providing a platform for subsequent dialogue between management and investors and other key stakeholders. It encourages management to take stock and to convey a clear, coherent account of their strategies and objectives and their success in implementing them. Nonetheless, whilst we are concerned at the manner in which the abolition of the statutory OFR was announced, the lack of due process involved and the poor precedent it sets for the determination of public policy, we do not advocate the reinstitution of any aspects of the former OFR regulations.
5. In our experience, the market is generally the most effective arbiter of the quality of a company's narrative reporting. Investors recognise and reward transparent reporting practices. In our comments on the draft OFR regulations, submitted to the DTI in August 2004, we warned that:

"the degree of prescription in the draft legislation regarding the contents of the OFR...is likely instead to encourage anodyne disclosures and a rigid approach by boards to OFR reporting. Directors will tend to focus on compliance with the detailed statutory requirements rather than developing useful company-specific and sector-specific types of disclosure that enable investors to truly view the business 'through the eyes of management'".

The late adjustments to the draft regulations did nothing to allay our concerns that this well-intentioned initiative may have resulted in bland narrative

reports, produced at a significant cost to companies but without any significant benefit to investors.

6. Recent surveys indicate that there have been some significant improvements in voluntary narrative reporting in recent years. The Institute welcomes these improvements and will continue to encourage listed companies to provide clear and concise voluntary OFRs in accordance with the ASB Reporting Statement as an aide to members and other investors seeking to forecast future cash flows and assess whether the business is capable of sustainable growth in economic value.

IMPROVING THE BUSINESS REVIEW LEGISLATION

The Scope of the Requirements

7. The business review requirements are generally non-prescriptive and high level. It would not be difficult to improve their coherence and scope - for example, by making it clear that the 'fair review' should focus first and foremost on an analysis of the strategic position of the business. However, they mirror many of the core requirements of the statutory OFR and, more importantly, seem unlikely in themselves to stifle innovative narrative and non-financial reporting by encouraging a rigid, tick-box approach. The relatively low quantity of disclosure provisions in place for the enhanced business review is more likely to compel directors to report from their own viewpoint, and consistently with the nature, size and complexity of their business. Whilst the success of the new regime should be kept under close review, we see no compelling reason to amend the content requirements at this stage.
8. If a decision were - against our advice - taken to augment the requirements of the business review legislation, a differential approach would be required. For non-listed companies in particular, the application of rigorous cost: benefit analysis and an understanding of the needs of the users of their financial reports is likely to confirm that the benefits of more extensive requirements would be outweighed by the costs of preparation.
9. In any event, any changes in the immediate future should be avoided in view of the weight of pending regulatory requirements applicable to UK businesses. For example, in 2007 listed companies will have to implement the requirements of the Transparency Directive, including publication of a new interim management report, and AIM companies will be required for the first time to apply IFRS.

Subsidiaries

10. There are no exemptions in the regulations for wholly-owned subsidiaries, unless they are small. In practice, unless such companies have material external obligations, little value is likely to be attributed to their separate business reviews. It is likely that there will be considerable time and cost

involved in producing the business review for such companies out of all proportion to the potential benefit.

11. We recognise that the wording of the EU legislation may prevent the introduction into UK law of any specific relaxations for subsidiaries. However, we suggest that the DTI discusses with the European Commission whether there is scope for relaxing the relevant requirements of the Accounts Modernisation Directive or at least for clarifying expectations in respect of wholly-owned subsidiaries.

LIABILITY ISSUES

12. The abolition of the statutory OFR has focused attention on the variable quantity and quality of forward-looking disclosures in narrative reports, and the limited prospects for any radical improvement in the near future in this area, principally as a result of concerns amongst directors over potential legal liability. This is a major concern in the context of both voluntary OFRs and the business review, as information with a forward-looking orientation - not necessarily capable of legal verification - tends to be highly valued by users of financial reports seeking to make rational economic decisions.
13. In our comments on the draft OFR regulations, referred to above, we emphasised that a simple rejection by the DTI of any form of 'safe harbour' would damage severely the prospects of success of the statutory OFR. We called, without success, for further debate and deliberation of the issue, involving close engagement with preparers and other interested parties. We believe that the company law reform bill before Parliament and the current market focus on narrative reporting provides a new opportunity to address perceptions about litigation risk. This opportunity should not be missed.
14. As advised in our letter to the Secretary of State dated 20 March 2006, we recommend that the DTI now explores as a matter of urgency the case for creating a 'safe harbour' in relation to forward-looking information, including information included in business reviews and voluntary OFRs. This will involve ascertaining the true extent of the relevant litigation risk. This is far from clear at present, and this uncertainty exacerbates directors' concerns. It will also involve exploring the merits of the various types of 'safe harbour' available, with due reference to the scope for unintended consequences and the impact of similar defences in law in other jurisdictions. An overriding requirement of whatever form of 'safe harbour' is adopted will be the imperative of satisfying perceptions that the mechanism will be effective and that uncertainty as to whether the 'safe harbour' will work will be minimised.
15. In our view, there are three main types of 'safe harbour' to be considered. Firstly, the legal sanctions otherwise attached to the general standard of care applicable to directors in the exercise of their duties may be disappplied in respect to certain classes of information. Secondly, certain classes of information may be exempted - in full, or in part - from that standard of care, substituting an alternative test, perhaps defined by reference to 'good faith'

and a lack of recklessness. And finally, agreed standards of behaviour may be established, without amending the underlying law.

16. In this latter case, market participants come together and articulate the standards they expect directors to adhere to, whether this is by reference to the generally applicable standard of care (as in the case of the 'Turnbull guidance' on internal control) or some other standard (as in the case of the guidance published by this Institute on prospective financial information in the context of the Financial Services and Markets Act). A clear point of reference - in effect, a 'safe harbour' - is thus established, but without any change to the underlying legal duties of directors.
17. A rigorous, evidence-based assessment of the regulatory choices would improve the prospects of reaching a broad consensus amongst business, regulators and investors and ultimately lead to better legislation and improved financial reporting. In view of the level of concern and uncertainty surrounding this issue, we have also recommended that a Ministerial Statement is made without delay, reaffirming the importance attached by the Government to the disclosure by listed companies of forward looking information and announcing that appropriate measures to address concerns over liability are being examined as a matter of urgency.

IMPROVING THE DTI GUIDANCE

Status

18. In December 2005, the DTI issued guidance on the business review, updating the guidance first issued in April 2005. The guidance is helpful in many respects, but its status may not be entirely clear. It carries the imprimatur of the Government, and simply states in the preamble that it '*has no legal force but is intended to help businesses understand the main features of the Directors' Report requirements*'. We suggest that the DTI emphasises as clearly as possible the non-mandatory nature of the guidance. This will be important when the Financial Reporting Review Panel begins to review directors' reports for compliance with the law.

Content

19. On balance, we do not favour the publication by the DTI of any further guidance on the *contents* of the business review. In our view, at this late stage in particular, new guidance would only tend to exacerbate the current confusion and uncertainty over the new regime. It would also lead to accusations of 'gold plating'.
20. The need for 'official' guidance on the new disclosures should be reviewed following the first year or two of experience of the new regime. However, even if presented as non-mandatory, further guidance might encourage a tick-box approach by companies preparing business reviews. In a real sense, the term *non-mandatory guidance* is an oxymoron. Good practice and common understandings emerge over time, through discussions between companies and

their stakeholders and through the good example of innovative reporters within a sector. Further guidance - especially if presented as suitable for all companies, including listed companies - could hamper this evolutionary process. Directors are likely to focus on compliance with the guidance rather than developing useful company-specific and sector-specific disclosures that enable shareholders and other users to truly view the business 'through the eyes of management'.

Boundaries

21. The DTI's guidance in a number of places appears to go beyond the boundaries of the legal requirements, straying without warning into the area of voluntary OFR reporting. For example, the guidance indicates in the introduction that companies will have to disclose information on the company's policies on environmental and employee matters and on the implementation of those policies. This lack of clarity is unacceptable, particularly given the application of the regulations to all companies other than small companies. Directors should not be misled over the true extent of their legal obligations.
22. Preparers are also referred to other guidance that was prepared specifically to assist companies to implement the statutory OFR requirements. The DTI should explain that such guidance may not be suitable in many respects for companies preparing a business review, especially unlisted companies, and should clarify that compliance with - indeed reference to - such guidance is in no sense obligatory. Multiple sources of guidance are likely to increase confusion and complexity, distracting directors from the primary purpose of the business review - to present their own view of the business, rather than information deemed relevant to the implementation of social policy objectives.
23. Finally, to avoid confusion, the guidance might usefully summarise the longstanding Companies Act requirements in relation to the directors' report that would impinge on the business review, for example paragraph 6(b) of Schedule 7. These provisions should be differentiated in the guidance from the new business review requirements.

Cross-referral

24. We welcome the recent amendment to the DTI guidance to clarify that it is acceptable to cross-refer from the business review in the directors' report to information included in a voluntary OFR. Information meeting the requirements of the business review might be found in elements of the annual report other than a voluntary OFR, for example in a statement by the Chief Executive. We therefore suggest the DTI guidance also confirms that in principle cross-reference from the business review to any part of the annual report is acceptable. This should allow directors to maintain the coherence and style of the annual report as a whole, whilst avoiding unnecessary duplication.