

30 May 2014

Policy Team
ICSA
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Dear Sirs

ICSA Consultation on Annual Report Contents

We are pleased to have the opportunity to assist and make a contribution to this consultation process. Our response is unique in that we probably have more relevant experience in respect of Annual Reports issued by listed companies than most other respondents. This should make our response to ICSA's consultation of particular value. For this reason we think it important to establish our credentials specific to this project and its consultation process before we go into the detail of our submission. The Institute of Chartered Secretaries and Administrators (ICSA) may not yet be aware of our authority on these matters.

1 Our credentials relevant to this consultation

FutureValue has been evaluating Annual Report narrative sections in depth for some nine years. In that time we have analysed more than three thousand UK listed company Annual Reports, along with others from Europe and further afield.

Our focused research on Annual Reports stems from work that we conducted for a client to use in the course of his contribution to Rosemary Radcliffe's 2003 OFR Working Group. One important outcome of this research was the identification of a broad, indicative correlation between what companies had to say about their strategic management in their Annual Report and their respective stock market performance.

Our principal interest has been to understand the quality of strategic thinking and its application to the business – past, present and prospective – as articulated in Annual Reports. Comparability is key, and bound by regulation, statute and good practice, Annual Report narratives offer a degree of indicative comparability on prospective performance, in the same ways as financial statements offer comparability between companies and across sectors in terms of past performance. To conduct this research properly we have had also to understand intimately and consistently the statutes and regulations that define the content of Annual Reports, as well as the way convention and good practice influence reporting content.

In the last three years we have augmented even further our capability to evaluate additionally governance reporting by UK listed companies through our associate firm, Bridgewell Corporate Communication, who are a leading practitioner in the reporting of corporate governance. Their support is increasingly sought-after, and welcomed, by many company secretaries, especially in the light of changes implemented in the last couple of years. Bridgewell also adds more than two decades of experience in the development of wider Annual Report content, communication and construction to our insight.

Between us we have actively been involved in advising on the annual reporting of well over 200 clients since 2002, some for several years, covering quoted and unquoted sectors, not-for-profit organisations and a significant overseas element.

We believe that this combined FutureValue and Bridgewell submission provides what will arguably be one of the most authoritative and valuable response to ICSA's Consultation on Annual Report contents.

2 Our recommendations

The following lists our principal recommendations:

- 2.1 Your introduction states that: *"This guidance is not intended to be prescriptive, nor is it intended to be a comprehensive list of all legal and regulatory requirements. It also excludes a list of contents for the financial statements."* Our experience suggests that a comprehensive list is exactly what users, especially listed companies, really want, as they wrestle with the sometimes conflicting, certainly confusing, ongoing deluge of legislation, regulation, guidance and opinion engulfing them (see section 3.1 below) This is why we focus on the regulatory whole, not just the Companies Act 2006.
- 2.2 This Guidance on Annual Report Contents needs to take account of the full range of statutory and regulatory provisions, not just a few of them, and to show through footnotes and reference that it does address the full range of these provisions. These are important to help establish the authority, reliability and validity of the final Contents list. The Consultation Draft seems to overlook a number of required statutory and regulatory provisions, by footnote reference at least, if not also in the course of the Contents list
- 2.3 Beyond regulation and statute, Guidance on Annual Report Contents should address also 'good', if not 'best' practice, as well as what is considered to be 'conventional' practice. The Consultation Draft addresses conventional practice but overlooks good practice
- 2.4 We suggest that the accepted purpose of the Annual Report needs to be re-framed in the light of the additive regulations, statutes and practice of the last decade. It is not just a matter of *"how the company has performed over the past year and how it creates long-term value"* but also of *"why it creates value and will continue to do so"*. This requirement is already enshrined in the UK Corporate Governance Code C.1.2: *"... an explanation of the basis on which the company generates or preserves value over the longer term (the business model)"* and so should be included here in this definition of the purpose of the Annual Report. Getting the definition right is pivotal as it influences the emphasis, scope and order of the Contents framework and list
- 2.5 The final Guidance on Annual Report Contents list should serve as an indicative framework rather than as a rigid template, in our opinion. This recommendation reflects practical experience, where some clients need the reassurance of a recognised structure, but others are confident enough to reshape it to meet their particular needs
- 2.6 The final guidance should also aim to transcend the current array of vested interests engaged in advising on Annual Report preparation. The Annual Report – narrative and governance as well as financial statements – is seen by some as the preserve of the accounting profession and auditors who are rightly responsible for assuring the accuracy of historical financial performance in the Annual Report. Accountants do not naturally or automatically have the requisite experience or skills to evaluate reporting either of narrative pertaining to prospective performance or, of corporate governance. Notably, the regulatory body for the Annual Report is the Financial Reporting Council. There is no 'Business Reporting Council' and this may reflect in part why BIS has requested ICSA to assist in this important project.

3 Our specific observations

The following sets out our specific observations of the Consultation Annual Report Contents:

3.1 A more comprehensive list of statutes and regulations that encompass or influence the Annual Report Contents is required – the following is a start:

EU legislation

Note that items 3.1.1-3.1.3 are incorporated into the UK regulatory framework, but the Accounting Directive is not fully implemented yet and its amendment was only announced in April 2014.

- 3.1.1 Transparency Directive 2004/109/EC
- 3.1.2 Fourth Company Law Directive 78/660/EEC and various amendments, including the Audit Directive 2006/43/EC
- 3.1.3 Seventh Directive 83/349/EEC
- 3.1.4 The 4th and 7th are repealed and replaced by Accounting Directive 2013/34/EU dated 20/7/13 to be in effect by 20/7/15. Note that there is already a directive passing through the EU legislative system at the moment that amends Directive 2013/34/EU

Primary UK reporting legislation

- 3.1.5 Companies Act 2006
- 3.1.6 Enterprise and Regulatory Reform Act 2013 – imposes voting on DRR

Principal secondary UK legislation amending CA06

- 3.1.7 Large and Medium Sized Companies and Groups (Accounts and Reports) Regulations 2008 – governance, especially Directors' Report and DRR content
- 3.1.8 Accounts, Reports and Audit Regulations 2009 – modifies LAMSCAGARR 08, mainly on the presentation of governance statements
- 3.1.9 Strategic Report and Directors' Report Regulations 2013 – splits and defines these reports
- 3.1.10 Large and Medium Sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013– modifies LAMSCAGARR 08, introducing the new Directors' Remuneration Report

UK Regulation

- 3.1.11 UK Corporate Governance Code 2012 – governance and business model – to be revised and supplemented Autumn 2014
- 3.1.12 Disclosure Rules and Transparency Rules, especially DTR 4.1, 7.1 and 7.2.
- 3.1.13 Listing Rules, especially LR 9.8.

Principal official guidance

- 3.1.14 FRC draft guidance on SRDRR13 (definitive version was due early in 2014, now due end June 2014)
- 3.1.15 GC100 Guidance on DRR
- 3.1.16 DEFRA Environmental Reporting Guidelines: Including mandatory greenhouse gas emissions reporting guidance June 2013

Other input

- 3.1.17 The International Integrated Reporting Council's Integrated Reporting Framework, issued in December 2013. The FRC was less than supportive of this in October 2013, but it is now mandatory in some jurisdictions, appears to have tacit support from some UK politicians and is widely promoted by Sustainability campaigners

- 3.1.18 Assorted commentaries from investor groups, NGOs, professional bodies, accounting firms, designers, and owners of sustainability reporting frameworks
- 3.1.19 It should be noted that there are internal inconsistencies in some of these reporting components, and even more inconsistencies and contradictions between them. These can be to do with specific content, but also with intent, such as the UK Corporate Governance Code's focus on materiality and de-cluttering and the Listing Rules' apparent requirement for boilerplate governance disclosure.
- 3.2 All narrative content provided by the reporting company should be within Strategic Report, Directors' Report or Directors' Remuneration Report to benefit from safe harbour provision (S263 CA 2006 and as amended by SRDRR13). This relates to Sections 1 through 9 of the Consultation Annual Report Contents
- 3.3 The most appropriate sequence of Contents should reflect a more logical order than is shown in the Consultation Draft. We have submitted a suggested Generic Annual Report Contents Framework as an Appendix to this submission. We would counsel that this should not be seen as a rigid template.
- 3.4 Sections 1 through 4 are central to the Narrative Report not apart from it. This makes the heading on Section 5 incorrect
- 3.5 Governance in the Chairman's Statement should be limited and should reference the more expansive and complete piece from the Chairman introducing the Corporate Governance Report
- 3.6 The Chief Executive's Review quite often incorporates the review of business model and strategy within the Strategic Report. These Chief Executive's Reviews rarely stick to just performance and KPIs without addressing strategy issues first
- 3.7 Frequently in practice there is unnecessary and irksome duplication between the Chairman's Statement and Chief Executive's Review. This draft Contents list in its literal interpretation would seem to endorse that with duplicated commentary on markets and environment and outlook
- 3.8 The Chief Financial Officer's review is another way of presenting the Financial Review, which is the usual place for narrative discussion and explanation of the financial statements and is a mandatory element of the Strategic Report
- 3.9 Section 5.1 seems to be in a sequence defined more by the order of items as they appear in the EU Directives/Companies Act 2006 [as amended by SR&DRR 2013/DTR] than reflecting any logical order that has become the stuff of established good practice. A typical 'good practice' order would constitute: market overview, business model, strategy, KPIs, Risks (KPIs and Risks are interchangeable here), and social and environmental resources and relationships. This suggested order, as included in the appended Generic Framework, follows the generally accepted and logical order of strategic thinking and its application to the business. So, a leader will first consider the external environment. He or she will then relate this market perspective to the internal realities of the business and the basis of its profitability, current and prospective, to define and explain the business model. The business model provides the context to articulate the business goals and set the strategic direction of the business, before presenting the strategy. The principal risks should be those that will directly influence the achievement of the defined strategic goals. KPIs should then provide some indication of strategic progress. The resources and relationships will illustrate how the company is developing the off-balance sheet capabilities that the defined future strategic direction and consequent success will demand. Many of the best corporate reporters are sensitive to, and apply this intuitive order in presenting their strategic management

- 3.10 Not everything that is set out in the Consultation Draft is an absolute disclosure requirement; business model, strategy, principal risks and gender diversity are but other disclosures are subject *"to the extent necessary for an understanding"*. An impression of compulsion creates a tick-list approach to completion
- 3.11 Common sense and good practice have established that the Directors' Report (Section 5.2) forms part of the Corporate Governance narrative (i.e. becomes Section 8.3). Various components of the Directors' Report may well be covered in the Strategic Report (results, future developments, post-balance sheet events, dividend, R&D, employees, diversity, GHG, inter alia) and should not be duplicated, but incorporated by reference. Some of the other material could also be usefully presented elsewhere in the Corporate Governance Report (names of directors, going concern etc.) and could also be incorporated by reference. Most good practice Directors' Reports are now a home for orphans of compliance reporting, and navigation aids to find compliance material that is better presented in context elsewhere. Note that some companies are using the Directors' Report as a repository for what is, in effect, Strategic Report material in order to reduce the size of their Strategic Reports, due to the error made by the legislation in replacing the Summary Financial Statements with the whole Strategic Report
- 3.12 Section 6 'Report on sustainability, ethics, values, and/or corporate and social responsibility' should form part of the Strategic Report, or the Directors' Report, for safe harbour reasons. We feel it should be part of the Strategic Report because the content is material to the discussion of the company's strategy in the round. If this social and environmental content is not material in this respect, it is clutter and should be presented elsewhere than in the Annual Report (per FRC guidance). The ICSA Consultation Draft already shows the inclusion of environmental, employee, social, community, human rights and gender issues in the Strategic Report section and this should encapsulate Section 6. Material GHG emission data could be included there, too. We recognise that this may change when the amendment to the EU directive on non-financial disclosure is implemented into UK regulation, should the Government of the day choose to add a legally separate CSR Report to the Strategic and Directors' Reports
- 3.13 The current location of Section 7 Board of Directors and the Secretary, as set out in the ICSA Consultation Draft has become custom and practice as a consequent of a simple design issue to enable the Board's photographs to be shown in colour, prior to a change to one or two colour printing for the old-fashioned reproduction of the Governance section when printing the Annual Report. The biographies should be explicitly part of Governance (Section 8), and fall into a useful position between Leadership (who the leaders are) and Effectiveness (why they are there), if the Corporate Governance Report is structured around the UKCGC framework as suggested below in point 13
- 3.14 The Corporate Governance Report is best structured around the UKCGC framework and its five principles (Leadership, Effectiveness, Accountability, Remuneration, Relations with Shareholders) to facilitate navigation and to engage users in the more dynamic style of governance reporting encouraged by the FRC. It is a moot point as to whether the required 'separate' committee reports (Nomination and Audit) should be physically separate, and come after the Corporate Governance Report, or whether they should be merely distinctly separate and be placed within the relevant UKCGC discussion – so Nomination Committee follows Effectiveness and Audit Committee follows Accountability. The Corporate Governance Report should form part of the Directors' Report, either by location or by reference for legal purposes
- 3.15 The Directors' Remuneration Report (Section 8.2) proposal is structured around the legislation (statement, report, policy). GC100 has recognised this structure to be unhelpful.

Logic suggests that an 'Annual Statement, Directors' Remuneration Policy and Annual Report on Remuneration' sequence is better

- 3.16 The Independent Auditor's Report is also governance material, especially with the increasing focus through the Accountability (especially UKCGC C.1.1) and Audit Committee narrative, and the requirement for the Auditor to comment on the whole document
- 3.17 An index (new Section 16) should be included.

We trust our response to the consultation is valuable and refer you also to our Appendix and its Generic Annual Report Contents Framework. We will be pleased to discuss this further with ICASA.

Yours faithfully

A handwritten signature in blue ink, appearing to read "Ian McDonald Wood".

Ian McDonald Wood FCA, MBA
FutureValue

A handwritten signature in blue ink, appearing to read "N. Wells".

Neville Wells
Bridgewell Corporate Communication

Appendix

Generic Annual Report Contents Framework

- 1 Strategic Report
 - 1.1 Overview
 - 1.1.1 Highlights
 - 1.1.2 Chairman's statement
 - 1.1.3 Chief executive's review
 - 1.1.4 [CFO's review alternate]
 - 1.2 Strategy
 - 1.2.1 Market overview
 - 1.2.2 Business model
 - 1.2.3 Strategy and objectives
 - 1.2.4 Principal risks and uncertainties
 - 1.2.5 KPIs
 - 1.2.6 Resources and relationships, social and environmental
 - 1.3 Performance
 - 1.3.1 Operational
 - 1.3.2 Financial [CFO's review]
- 2 Governance
 - 2.1 Corporate Governance Statement – incorporated into the Directors' Report 2.3 by reference
 - 2.2.1 Chairman's statement on governance
 - 2.2.2 Compliance statement
 - 2.2.3 Leadership
 - 2.2.4 Biographies
 - 2.2.5 Effectiveness
 - 2.2.6 Nomination Committee Report
 - 2.2.7 Accountability
 - 2.2.8 Audit Committee Report
 - 2.2.9 Relations with Shareholders
 - 2.2 Directors' Remuneration Report
 - 2.3.1 Annual Statement
 - 2.3.2 Directors' Remuneration Policy
 - 2.3.3 Annual Report on Remuneration
 - 2.3 Directors' Report
 - 2.4 Independent Auditor's Report
- 3 Financial Statements
- 4 Shareholder information
 - 4.1 Financial calendar
 - 4.2 Company information
 - 4.3 Registrar and corporate advisers
- 5 Glossary and reference to online information
- 6 Index