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## **The Future of Narrative Reporting – Consultation Response**

We submit in this document our response to the consultation on narrative reporting by the Department of Business Innovation and Skills. In the section immediately following is a background to the Strategic Planning Society (SPS), including relevant information to confirm our authority underlying the facts, comments and opinions that we express herein.

### **The Strategic Planning Society and its credentials**

The SPS is at the heart of a community of some 7,000 strategists of whom a significant proportion are based in the United Kingdom and are fully paid-up members of the Society. Members of the strategy community come from business, academia and the third sector. The Society's core purpose is to foster and promote research and best practice in strategic thought and action. Our opinions here are expressed as experts in strategy and as a Board of Trustees responsible for the development of strategy as a management technique and practice.

One of our key research themes in recent years has been to understand the efficacy of strategy in business expressed through the corporate reporting of listed companies. Best practice guidance and regulation provide a framework that encourages companies to articulate their strategic thinking, their capacity for effective strategic management and their investment in strategic capability. It has also enabled SPS to assess comparatively the success achieved by companies as a consequence of reporting strategy effectively. Indeed, we now recognise annually the very best reporting by listed companies in our 'Strategic Value in Corporate Reporting Awards'. The painstaking research work of the Society's Chairman on this has enabled us to assimilate a considerable body of knowledge in this area and formulate opinions as a result.

Founded in 1967 SPS has played a role in the emergence of strategy, founding one of the leading and respected academic research journals in strategy, LRP. It is a registered charity whose charitable object is education in strategy. SPS has

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recently assumed the greater responsibility now expected of it, and is extending its role to help evolve strategy as a recognised and valued professional discipline. To this end SPS has re-framed its own ambition, refining its mission and its vision *"to be the leading professional body for strategy and strategists, and to be internationally recognised as this"*. This ambition reflects newfound leadership of the current Board of Trustees of the Society under its current Chairman. We are now working resolutely towards achieving this aspiration.

### **Our response to the Narrative Reporting Consultation**

Our response addresses directly the thirty-five questions designated in the 'response framework'. We have included only those questions to which we can provide authoritative and informed comment or opinion. We have omitted those questions that we do not feel qualified to address.

#### **Q1 Do you agree in principle with restructuring the current reporting framework into a Strategic Report and an Annual Directors' Statement?**

We concur strongly with the restructuring as proposed here. We agree that this new proposed reporting framework should in theory add considerable value to stakeholders in general, and to investors in particular, but only if properly executed. Currently, few companies seem able to articulate strategic thinking effectively, and this applies to many FTSE100 companies as well as to listed companies more widely. We address our concerns and possible solutions to some of them in response to the succeeding questions.

#### **Q2 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?**

The quality of strategic thinking in UK Boardrooms and Senior Executive Teams is generally mediocre judging by the quality of strategy as currently reported by FTSE350 companies. For example:

- The new UK Corporate Governance Code requires companies to include their business models in their Annual Reports. Yet, very few companies know what their business model is as the foundation of their strategic thinking. This may come as a surprise but it is already evident that most companies fail to get this right. Many simply do not comprehend what is a strategic business model, misinterpreting it as their operating model
- A corporate goal or objective defines the ambition or intent of a company or group of companies. It sets out the strategic direction, enables the strategy and establishes in stakeholders' minds the company's future potential. Yet, in 2010, one quarter of FTSE350 companies declared that their only goal was an unspecified 'increase in shareholder value'. This simple, obvious and generic financial goal states the blindingly obvious. It does not set strategic direction, and renders it almost impossible to interpret whether the underlying strategy reported is both necessary and sufficient, or even makes sense
- Most companies continue to report the risks of simply being in business, rather than the risk factors that may influence their capacity to achieve their

strategic goals. For example, a significant proportion of companies report 'Competition' as a 'principal risk or uncertainty', yet it is common to every company and understood by most investors as a general risk. Even more worrying is the fact that it is more likely to be the only mention of competition in most Annual Report narratives

- For many companies 'Key Performance Indicators' are financial metrics. These obviously indicate financial achievement and are unlikely to report adequately strategy in action. Only if there are clearly stated business goals can KPIs illustrate strategic progress. KPIs are seen in too many cases as simply the means to report bonus-earning performance
- Many companies report social and environmental factors without trying to integrate them effectively with the economic factors of the business, to capture the reality of a strategically sustainable entirety
- Few companies explain how their Boards are involved in, and take ownership of, the strategic agenda and its successful implementation beyond passing compliant reference in their corporate governance reporting. This strategy governance process is as important as the actual content of the strategy and its application.

We agree that the content as summarised in Question 2 looks appropriate. But we believe that there needs to be clear and unequivocal guidance on what these components are and how they should fit together in a robust and effective strategic framework. This should also seek to provide guidance on strategy content for groups of companies as well as for single business unit companies. This should be definitive but not seek to undermine the principles-based approach of UK reporting. We address this guidance in more detail in our response to Question 33 below.

Given that the quality of reported strategic thinking, even among the UK's largest cap listed companies, is highly variable and that the benefits of doing it consistently better seem to be substantial [we have indicative evidence], the scope of this proposed regulation should ideally extend more widely than merely to listed companies. This would then benefit fully UK business and society more radically. But, we recognise and accept, wider application is unlikely to be a practical consideration for the time being.

**Q3 Do you agree that the proposed Strategic Report should replace the Summary Financial Statements?**

Yes. The number of companies currently issuing Summary Financial Statements is falling away considerably and those that retain them seem to adhere to the minimum requirement. We think it will need careful specification in any revision to company law to ensure the specification of the Strategic Report is inclusive but not restrictive.

**Q4 Do you agree that the Strategic Report should be signed off by each director individually?**

Yes. We believe that individual ownership of strategic direction and performance should encourage more attention by each director to the articulation of strategic thinking. At present the only expression of the Board's ownership in setting the

strategic agenda and in monitoring its performance is typically a passing compliant reference in the 'Corporate Governance Report'. Strategy process is as important as strategy content but this reality seems to be largely overlooked.

**Q5 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)?**

We are unable to comment on the full scope of content for the Annual Directors' Statement, but agree with the intent. We wish to point out that Board involvement in governance processes related to setting the strategic agenda, addressing strategic risk, monitoring performance, overseeing social and environmental factors should be in the Strategic Report to which they will directly relate and not in the Annual Directors' Statement where they will effectively be widowed.

**Q6 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)?**

Yes. We understand that auditors can currently be a considerable brake on companies making progress on this. Companies should be encouraged to do this through hyperlinks that add a pop-up note saying 'You are leaving audited content' where this is the case. This ought to satisfy auditors.

**Q7 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?**

Yes. There is a need to impress that both Strategic Report and Annual Directors' Statement are dynamic reporting documents.

**Q8 Do you agree that the Annual Directors' Statement should be presented online with a hard copy available to shareholders only on request?**

Yes. It should be available online in HTML or as a browse-able PDF-style viewer and offline in PDF derived from the print version.

**Q13 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?**

Interpretation of the regime varies from company to company. We understand that this will often depend upon the role of the Chief Legal Officer or General Counsel in the corporate reporting process. The widest variation is among companies issuing American Depositary Receipts and having to produce an SEC 20-F reporting prospectus. A dual-purpose reporting document to meet US and UK reporting regulations is always a compromise with some companies doing it

well, some badly and many making a mediocre effort. The US liability régime seems to affect UK attitudes and consequent reporting. The litigious nature of US society makes some US/UK dual-listed companies careful about what they publish in the UK in case US investors access UK reporting. This is preposterous. A prime example of the adverse impact of a dual-purpose reporting document is in the differing requirement of reporting of risk factors. Most dual-purpose reports will apply the 'lowest common denominator' approach. This leads to a long list of very broad risk factors without any reference to how these are controlled or managed to minimise their occurrence or potential impact.

Publishing a meaningful Strategic Report as part of a dual-purpose US-UK reporting document, i.e. to meet SEC 20-F requirements, will be well nigh impossible. The UK principles-based approach to corporate reporting is far more useful than the US rules-based approach. The UK Government should therefore prevent this dual-purpose reporting from persisting. While companies may balk at extra cost they should reap the benefits of more meaningful reporting.

**Q15 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?**

Yes and yes. A more transparent method of establishing executive director and senior executive performance is essential. It will only be really useful if there is genuine comparability across sectors and across the market.

**Q19 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?**

It may be possible to relate remuneration to performance in the relevant year, but not to strategic objectives. For a significant proportion of companies 'increasing shareholder value' is the only declared generic strategic goal, and not even a specified objective. How do you relate remuneration to that? For others a strategic objective is simply an annual threshold or target financial measure of some sort. So, it will be possible to relate remuneration to performance and to short-term objectives in these cases. But, the most useful information would be to relate remuneration to the achievement of medium- or long-term strategic objectives. It is difficult to see how this might be possible at present.

**Q20 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?**

Assessing remuneration against historical performance will be considerably easier than relating remuneration to strategic objectives. Total Shareholder Return is the easiest way to assess strategic value added and probably the preferred method. Earnings Per Share would be a good additional measure of real value creation by the CEO over a five-year period. These are both consistent and understood performance metrics.

**Q21 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?**

The answer to this question is subject to the same constraints as those identified in the response to Question 19 above. There will need to be a clear definition of what are acceptable as strategic objectives for this to be possible.

**Q29 Do you agree that the current legislative regime for audit and assurance for narrative reporting is adequate for your needs?**

The current regime for audit and assurance of non-financial information is of questionable value. Auditors who are accountants are assessing the narrative sections of the Annual Report for their consistency with the financial statements. So long as that is all they do it is fine, but it allows a misperception among stakeholders that the auditors have audited the narrative content of the Annual Report as well. They haven't.

Accountants develop a historical mindset in training and practice, whereas strategy requires a diametrically different future-focus, also acquired through training and experience. Accountants do not currently undergo the training to be able to assess all the content of a Strategic Report properly. Business model, objectives, strategy, risk, social and environmental sustainability content – these all need the practised eye of someone trained in strategy and in sustainability. David Phillips, the retiring corporate reporting partner at PWC, has readily agreed that accountants need to receive training in strategy to be able to conduct a more complete assessment of the reporting narrative.

**Q30 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?**

We do believe that assurance of the Strategic Report needs to go further but do not have an immediate solution for this that would not add cost to the process. See our response to Q33 below.

**Q33 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?**

Clear guidance on strategic frameworks, business models, strategic objectives, corporate strategy, risk, KPIs and social, economic and environmental sustainability – all with examples – is essential and would provide a knowledge base for the senior executive teams in companies and for accountants and auditors alike.

We believe this should extend to essential training for directors – the quality of strategic thinking and its application is generally mediocre among FTSE350 companies. We believe it should extend also to training among accountants undertaking audit roles, as noted above in the response to Question 29.

The SPS will put itself forward to co-ordinate a high-level panel of strategists who could undertake the development and production of the guidance material required for the Strategic Report on behalf of the Accounting Standards Board. Perhaps the name 'Accounting Standards Board' even gives the wrong impression in respect of presiding over the Strategic Report?

**Q 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**

We cannot see how the production of a true Strategic Report can remain entirely voluntary, as it will require a more resolute adherence to a defined strategic framework and to the components of strategy if it is to achieve more than merely to pay lip service to its name as a 'strategic report'. This applies equally to the inclusive reporting of social, environmental and economic sustainability as an integral component of strategic thinking and reporting.

It is important, in our opinion, for the UK to retain its principles-based approach to corporate reporting and not fall into the trap of adopting a US-style rules-based approach. But, we feel a voluntary requirement is unlikely to achieve a standard valuable enough to companies and their stakeholders. In the latter we include UK society and the UK economy.

**Q35 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?**

The Society is firmly of the opinion that the profile and working practices of the FRRP will need considerable enhancement to be able to oversee effectively the new régime of narrative reporting generally, and Strategic Reports specifically.

At a recent meeting of Audit Committee Chairmen it was slightly disturbing to hear a senior figure from the FRRP comment that he was unclear why strategy should be so important in terms of corporate reporting as a company rarely changed its strategy. He also explained in answer to a question that it was the FRRP that requested the FRC to include, when drafting the recent UK Corporate Governance Code, a requirement for companies to report their business models. His subsequent comments also suggested that the FRRP did not wholly appreciate the distinction between a strategic business model and an operating model. We do not know what the FRRP is now expecting companies to report. We are not sure that they know either.

**The benefits to the UK of getting it right**

We strive to recognise those companies that are the very best in their articulation of strategic thinking and management in their Annual Reports, so that we can make our annual Awards. In the process, and over several years, we have confirmed the undeniable benefits that accrue to strategically literate companies:

- There is a correlation between companies that demonstrate clarity and rigour in terms of their strategic thinking and action and their performance in the stock market

- Clear and rigorous strategic narrative helps to retain analyst and investor confidence in harder times, serving as a brake on market volatility for effective companies relative to their sectors at the very least
- Good strategically focused narrative reporting also leads to value creation by companies over the medium term
- A simple robust strategic framework provides uniquely the milieu to integrate social, environmental and economic dimensions of a business effectively and rationally.

These benefits do not and will not accrue easily to companies that simply go through the motions in their narrative reporting as many do now. They are likely to continue current practice in producing a 'Strategic Report' without encouragement, guidance and even training.

We trust our response to the consultation is helpful.

We remain at your service

Yours faithfully

A handwritten signature in cursive script that reads "Paul Barnett".

Paul Barnett  
Executive Officer  
For an on behalf of the Board of Trustees