

An End to Second-rate Annual Reports

by Ian McDonald Wood

How many private investors read the Annual Report and Accounts of the companies in which they invest? Some will look at the financial statements and the notes to the accounts. However, it seems that very few even do this and most pay scant regard to the narrative sections of the report. So what is the purpose of the annual report? In the constant drive to set rules, draft supporting guidance and define requirements for compliance, have regulators and industry bodies lost sight of the original objective? Ian McDonald Wood of FutureValue considers a number of issues that concern all of us as investors.

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BEIS recently asked investment trade bodies to engage with listed companies and encourage them to give better evidence of long-term decision making. Quick to respond the Investment Association (IA) published Guidance on Long Term Reporting addressing five searching strategic topics and themes missing from most companies' Strategic Reports. But, surely, reporting companies already have more than enough from the FRC and others? The reality is that mere compliance rules. Declining and already meagre UK equity holdings by UK institutional investors and of reducing duration suggest few companies will pay attention. Evidence of long term value creation in reporting will surely remain elusive. Most companies will continue to go through the motions of reporting, dismissive of the quite considerable benefits they are foregoing. So, is shareholder primacy as the driver of corporate governance dying on its feet?

In its recent Report on Corporate Governance [5/4/17] the Department for Business, Energy and Industrial Strategy (BEIS) made a point of acknowledging the rapidly changing ownership structure of UK listed companies. In particular, it referenced Bank of England Deputy Governor, Andy Haldane's observations about the emergence of "ownerless" companies, where "it becomes harder to exert influence over management, increasing the risk of sub-optimal decision-making". This BEIS report concurred that dispersed ownership impaired long-term decision making, as companies' management teams felt duty bound to maximise short-term profitability and dividend payouts. Referencing specifically the Investment Association and more recently established Investor Forum, BEIS called on bodies representing the investment community to take a more proactive role in promoting higher standards of stewardship and engage with companies to encourage longer-term decision making. Reporting by companies, BEIS says, should provide the evidence of that longer-term decision making.

As if on cue and within a month of the BEIS report on corporate governance the Investment Association published its 'Long Term Reporting Guidance'. The Guidance's logic is quite straightforward. The ability for investors "to assess a company's long term prospects, and identify those able to deliver sustainable value creation to shareholders over the longer term" is largely dependent on a company's Annual Report. The Annual Report "should strive to provide a true long term understanding of the business and its drivers, its financial strength, and the quality of management and their decisions." IA simply spells out here some additional reporting topics that, properly addressed, would add a genuine strategic dimension presently absent from most Strategic Reports – real strategic business models, specific evidence of investment in productivity improvements; capital management and efficient capital allocation; proper strategic risk management; and, human capital and culture. This is commendable stuff.

The publication of yet more Guidance, albeit by a trade body, is evidence enough that evidence of long-term decision making is just what most Annual Reports need and currently do not provide, despite the FRC's own and now long-standing 'Guidance on the Strategic Report' [2014] and ensuing detailed regular Annual Reviews of Corporate Reporting. One can only conclude that companies typically pay scant respect to what the FRC has said that the Strategic Report is intended to communicate, and get by with mere uninformative compliance. That there is a need for IA to spell out its members' expectations should be of concern to investors generally. Four years after introduction of the Strategic Report the overall standard of narrative reporting by the FTSE350 remains second-rate. This is not just the logical conclusion behind the IA's Guidance publication, it is also the reality. FutureValue's analysis and evaluation of strategic value in UK corporate reporting by FTSE350 and other listed companies over the last decade has shown only a small minority of companies effectively explaining and projecting evidence of long-term value creation in their Annual Reports. We do not see the general improvement that others such as The Purposeful Company initiative

and even the FRC claim. We just see in most cases more, not better narrative content.

And perhaps there is a greater concern that universal evidence of long term value creation in corporate reporting will remain forever an unreachable holy grail. Members of the Investment Association representing the breadth and depth of UK institutional investment are now reportedly holding less than 13% of their investment in UK equities. The duration of UK equity investment holding is also apparently declining to an average of 6 months. With declining UK shareholder involvement why would Boards and their executives pay any heed to the IA's ministrations and respond to its Guidance – any more than the generally lacklustre attention they give to the regulatory and statutory demands of the reporting regulator? Given that most companies remain dismissive of the significant potential benefits that will accrue from high standards of reporting, we have to conclude that nothing will change. Most will continue to go through the motions of reporting, indifferent to the benefits they are foregoing and committed in the majority to endless mediocrity, however good the IA's Guidance may be – and it is good.

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