THE INVESTMENT ASSOCIATION

FRC Discussion Paper on the Future of Corporate Reporting

IA Response

About the Investment Association

The Investment Association ("IA") champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £8.5 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 40% of this is for overseas customers. The UK asset management industry is the largest in Europe and the second largest globally.

Introduction

The investment industry's purpose is to generate sustainable value and to meet their client's investment objectives. These clients are individual retail savers and institutions like pension funds, insurers, charities, and governments. Our members invest on behalf of millions of savers in the UK and around the world, seeking investments that deliver long-term, sustainable value. Long-term value assessments of investee companies are not limited to share price performance or dividend yields. Investors take a more holistic approach. This involves integrating into the investment process a wide range of material issues including environmental, social and governance (ESG) factors which present risks and opportunities to the long-term value of the company. Investors want to ensure that companies are well governed and addressing material risks to their long-term value. This is to the benefit of the end savers, who are seeking long term returns from their investments.

The quality and consistency of the information provided by investee companies is critical in supporting this endeavour. Corporate reports should provide investors with the information to enable them to develop a real understanding of a business and its drivers, its financial strength, the quality of management and the material risks and opportunities they are managing. These disclosures enable investors to make more efficient capital allocation decisions and informs their engagement and stewardship activities.

The IA welcomes the FRC's review into how corporate reporting can be made more effective and engaging for all stakeholders and is grateful for the opportunity to provide commentary on the discussion paper. Whilst investors are the primary users of corporate reports, we recognise that these disclosures also provide valuable information for a wider range of stakeholders and play an important role in increasing public accountability. Below we have set out some key areas that this review should address. Any alterations to the future of Corporate Reporting should promote:

- the integration of financial and non-financial information, both to support ongoing efforts for investors to integrate ESG considerations within the investment process and to support with the public transparency and accountability of companies; and
- global efforts towards standardisation of non-financial information reporting.

The IA is concerned that some of the proposals in this discussion paper may not support these aims. We are also concerned that the proposals to create individual reports each with varying levels of materiality and assurance will have negative implications for the usability of the reports and may introduce a disproportionate reporting burden for UK listed companies.

These concerns are explored in further detail below.

Separation of material non-financial information from the financial statements

The IA recognise that corporate reporting needs to serve the interests of an increasingly wide range of stakeholders. However, the IA is concerned the discussion paper's proposals to create separate reports would artificially separate the financial and non-financial information and may not best reflect the needs of different stakeholders. This would include the proposals that non-financial reporting be collected under two separate documents (i) the business report (similar to the current strategic report section of annual reports) and (ii) a new public interest report. There is a risk that separation of these reports leads to a reduction in the quality, completeness and strategic nature of company disclosure on how they are managing long-term risks and opportunities and will act as a barrier to the integration of ESG factors into the investment process.

The integration of ESG factors into the investment process leads to a more efficient and productive allocation of capital, resulting in better outcomes for clients. This should also result in positive impacts for society, the environment, and the economy. The IA therefore welcomed the 2020 Stewardship Code's expectations that signatories disclose how they have integrated material ESG issues and stewardship in the investment process.

The successful incorporation of ESG factors into the investment process is contingent on a system of corporate reporting that allows companies to inform investors about the key drivers of long-term risk and value creation. Companies' activities have an impact on society, the environment, and the economy; these in turn impact on the financial performance of a company; and that the society, environment and economy in which companies operate also present risks and opportunities to their long-term value. There is a clear continuum between the need to create sustainable value for investors and the wider impacts of company activities on society and the environment. Different global standard setters are working together to develop a globally accepted comprehensive reporting system that takes account of this continuum or the 'double materiality' perspective[1]. This lends itself to the integration and not separation of financial and non-financial reporting. Therefore, any future framework for corporate reporting needs to be consistent with the emerging global consensus.

The management of risks and opportunities presented by ESG issues should be a central component of a company's strategy and business model and not a separate issue. High-quality corporate reporting should include disclosures that reflect this. The best corporate reports in this respect adopt an integrated approach to corporate reporting that integrate information about material risks and opportunities arising from non-financial information alongside financial and strategic risks and opportunities. Quantitative data is provided alongside qualitative assessments of their impacts which allow investors to make more comprehensive assessments. The best corporate reports also link this information to key financial information around the company's capital management which

[1] https://29kjwb3armds2g3gi4lq2sx1-wpengine.netdna-ssl.com/wp-content/uploads/Statement-of-Intent-to-Work-Together-Towards-Comprehensive-Corporate-Reporting.pdf

helps set out how they can transition their business model to be more sustainable over the long-term.

The proposal to separate financial and non-financial information runs counter to the best practice approach of integrated reporting and could act as a barrier to the further incorporation of ESG issues into the investment process. Indeed, this approach is not aligned with the FRC's own endorsement of the IFRS' proposals to create a Sustainability Standards Board to promote the integration of financial and non-financial information reporting into a common architecture.

It is also important to note that the investment objectives of many investment managers and their clients are not limited to financial returns, but can also include non-financial elements, such as to invest in companies or projects that deliver social or environmental benefits or that "do no harm'. Mandates for a wide range of responsible investment approaches including impact investments are growing - responsible investment funds saw net retail sales treble to £10bn in 2020, compared to £3.2bn in 2019. The artificial separation of different stakeholder objectives in the proposed reporting approach is therefore not representative of the wide variety of interests and investment objectives of investors.

Global Standard Harmonisation

The IA welcomes the discussion paper's aims to encourage greater accountability and wider stakeholder engagement. Critical to ensuring that the value of corporate reporting is maximised for all stakeholders is the global harmonisation of standards for sustainability issues. Indeed, the Asset Management Task Force's Report - 'Investing with Purpose: placing stewardship at the heart of sustainable growth'[2] recommends that 'regulators and investors should continue to support ongoing international efforts to enhance and harmonise corporate reporting standards for sustainability.' Efforts to 'future-proof' corporate reporting should first seek to ensure the quality and usefulness of the information being reported.

The current proliferation of reporting frameworks and standards has led to a disparate picture in the disclosure of sustainability issues. The reporting of non-financial information and intangibles is currently characterised by a lack of consistency, comparability, and reliability. With no single standard to report against, individual companies are choosing different frameworks. The disclosures are therefore not always suitable for use in the investment process and are not satisfactorily robust to be included in empirical modelling. This results in a wide range of market inefficiencies including increased costs from duplicated reporting, verification of ESG data and the potential mispricing of assets.

The FRC's initial focus should be on the promotion of a globally harmonised standard for the reporting of non-financial information. With such a standard the information disclosed in corporate reports, regardless of its presentation or what stakeholders its aimed at, will be more reliable, allow for comparative analysis, and be more valuable to all stakeholders. This is the first, and most important step to ensuring that company reporting meets the increased accountability demands and empowers stakeholders to hold companies to account on creating long-term value and making tangible progress towards sustainability goals. The IA and the AMTF welcomed the FRC's statement reinforcing its support for international harmonisation of reporting standards and we encourage the FRC to focus on engaging with other organisations and commit resources to achieve that goal.

[2] https://www.theia.org/media/press-releases/investment-managers-place-stewardship-heart-sustainable-growth

Usability and Assurance

As the primary end-user of corporate reports, investors are aware of the growing length of annual reports, the dispersed nature of their contents, and the implications on overall usability and accessibility of corporate reporting. However, we believe that the creation of a network of reports is counter-productive to the stated communication objective of brevity, comprehensibility, and usefulness.

As the discussion paper acknowledges, the interest of different stakeholder groups are not mutually exclusive, and so individual reports for the different stakeholder groups will have to duplicate a substantial portion of the information in each report, or alternatively, extensively refer to different reports for the relevant information. This will likely result in a body of corporate reports that is longer than the current annual report, and much more fragmented. The outcome of this is a reduction in the overall usability of stakeholders interested in gaining a comprehensive understanding of a company.

Corporate reporting requirements should balance the needs of investors and other stakeholders for transparency and accountability with the reporting burden for companies, in order to support efforts to promote the UK as an attractive place to list and invest.

Further compounding concerns about the usability of the network of individual reports is the lack of clarity regarding the level of materiality and assurance applied to the information disclosed within different reports. For the information disclosed in the reports to be useful in the investment process and increase the engagement of wider stakeholders, there needs to be underlying confidence in the quality and accuracy of the disclosed information. We believe that in the long-run, non-financial information should be subject to a mandatory audit, however greater global harmonisation needs to be achieved before this step. In lieu of a mandatory audit, there needs to be clarity on the level of assurance provided so that investors and other market participants will have the confidence to use the disclosed information to make decisions and assessments about the company. The IA looks forward to working with the FRC in aiding the implementation of the Brydon Review's recommendation where they relate to corporate reporting.