HERMES INVESTMENT MANAGEMENT

INTEGRATED REPORTING <IR>

Moving forward:

The road to better integrated reporting

In late November 2015 Hermes EOS, Black Sun and the IIRC convened an informed group of corporates, investors and analysts to discuss how they could improve the relevance and reliability of corporate reporting.

This event marked the first in a series of activities which look to explore how engagement between various stakeholders in the investment chain can be improved to encourage better reporting, management, analysis and decision making. While we do not have all the answers our collective aim is to share experience, stimulate debate and drive action that results in measurable change that improves understanding between companies and investors.

Context

The context for the discussion is built on market research which shows that investors want to take into account wider information in investment decisions over and above financial performance. This reflects their growing understanding of the increasing value of the broad base of capitals that businesses use in their operations.

However it appears that while investors want this information they rarely use it as they are concerned by its reliability and comparability. Furthermore, companies assert that wider information is available but it is not asked for by investors and is not used by analysts in their models.

Summary

The discussion was wide ranging and considered all sides of the investment chain. Overall there is a clear business case for using reporting as a mechanism for better understanding and engagement. High-level stakeholder views that captured overall sentiment from the discussion included:

- Corporate reporting system challenge: '…*The broader reporting framework should promote a leaner, more meaningful and connected structure that meets all criteria in a simpler way…*'
- The company challenge: '…*Coming up with non-financial measures that are comparable, that management can use and are externally facing are a challenge…*'
- The analyst challenge '…*The buy-side needs to provide more feedback and refocus the sell-side on longer-terms aspects of reporting…*'
- The investor challenge: '…*Some members of the financial community are lazy, by just demanding more and more (ESG) metrics, without trying to understand the individual circumstances of each company…*'

What the debate confirmed

The discussion reaffirmed a number of important areas highlighted in research ranging from the continued relevance of the Annual Report through to the quality of reporting as a proxy for good management. The key highlights included:

The Annual Report is of significant value to many audiences:

- The Annual Report is clearly seen as the most valuable source of information, ahead of data-providers, sell-side research and company press releases.
- It is the primary source of information for investors and other key stakeholders and serves readers across an ever increasing audience of employees, suppliers, regulators, media and the general public. This has implications for the preparers, as the report now has to be written with different audiences in mind.
- As a reference it was viewed that the Annual Report is most useful as a single publication, with coherent Annual Reports telling a clear business story – flowing from strategy, to business model, to risk management and cash generation.
- The financial review in the Annual Report is seen to aid comparability across industries and markets as it is based on a common set of accounting standards.
- In contrast it was acknowledged that important 'non-financial' information – in relation to governance matters and environmental, social and human capital topics – is more 'bespoke' to each company and has fewer standards for measurement and reporting making comparability more difficult.
- In terms of the broader structure, 'fair, balanced and understandable' requirements, the strategic report, the viability statement and the <IR> International Framework are seen leading to more balanced, integrated and insightful reports.

Engaging the sell-side community to help companies develop improved company information remains challenging:

- It was viewed that analysts continue to be quarterly focussed although it was appreciated that this is partly driven by banking, fund management and hedge fund business models which pay for research out of trading revenues.
- Some were frustrated that short-termism resulted in a failure of analysts to appreciate the volume of corporate information already available. Additional disclosure wouldn't necessarily result in significant changes to corporate valuations.
- There was also recognition that while the sell-side has changed significantly in the past few years, the impact and voice in the market of short-term traders and investors is disproportionate to the size of their holdings.

Societal short-term pressures (information rich - attention poor), time preference and impatience are still considered major headwinds:

- It was considered that short-term noise related to quarterly reporting should be ignored and that high-quality reporting should drive the debate.

Participants regard the quality of reporting as a proxy for good management:

- There is a belief that bad reporting not only impacts the reputation of board members but can cause investor unease and highlight risks for analysts that can impact valuation through a higher cost of capital.

Actions for participants

Knowledge sharing between attendees and our joint experience of working with and supporting companies, we offer some suggestions on how better understanding between all stakeholders might be developed.

Reporting system actions:

- **The language of ESG needs to be re-examined:** At its core the ESG lexicon has become a barrier to engagement and prohibits analysis. The proliferation of acronyms has led to analyst disengagement, which has resulted in the marginalisation of key business risks that are fundamental to company analysis. The language of ESG needs to be translated into simple, accessible language. The market needs to understand that ESG is not a fad but represents a core of information which many investors and analysts use. From a corporate perspective ESG needs to be embedded into the core business model and seen by management as an intrinsic part of the value creation process, along with other resources such as human and intellectual capital. The various reporting initiatives could work more closely to define best practice.

Corporate actions:

- **Senior business leaders need to promote more relevant performance metrics:** Companies need to have a clear understanding of their purpose as this leads to the development of relevant performance metrics. KPIs need to have a transparent explanation as to why they have been chosen and why they are relevant to understanding the performance of the business. There should be measurable data on employee and customer engagement, health and safety, and diversity programmes. Company management need to also understand that there is a genuine cost to good reporting and that this requires sufficient resource and people.
- **Companies need to help the investor and analyst community in navigating their disclosures:** Annual Reports need to include sufficient cross referencing. This not only encourages the flow of the equity narrative but helps surface insightful and valuable information which would otherwise be overlooked.
- **Companies need to 'push back' on unnecessary requests for further disclosure:** Questions can often be answered directly rather than creating additional layers of disclosure which might be of little value.
- **Companies should explore the benefits of digital:** Stakeholders want to understand the skills of directors, their independence, governance structures and engagement strategies. Digital assets, such as video, that increase transparency are of value as executive time is not scalable in the context of a large investor base. Although better use of electronic linking is appreciated, it was argued that websites have the risk of information dropping off or becoming a 'dangerous dumping ground' and need to be well managed.

Analyst and investor actions:

- **Analysts and investors should assess what information already exists:** While analysts and investors are under significant pressures, companies already produce a significant amount of information which is in the public domain. Rather than requesting new disclosure analysts and investors should assess what information exists. As a starter, remuneration reports offer a great insight into what management teams are aiming for in the short-to-medium term.
- **Analysts and investors should explore ESG issues in greater detail:** Analysts and investors should be more thorough in their approach of exploring key ESG issues with companies, focusing also on the important qualitative information behind the reported metrics.

While these recommendations will not on their own transform the debate around the quality and use of wider company information, they do provide the opportunity for incremental improvement which could result in renewed dialogue and better understanding between investors and companies. There needs to be more recognition that integrated reporting, by promoting a more balanced approach, improves transparency of risk, offers management more insight into their business and better engages the shareholder base. This can lead to better board performance and could lower the cost of capital.