Dr. Helmut Maucher
An Interview with the
Honorary Chairman of Nestlé
pages 06-09

Reflections on Gulf
Corporate Governance
In-depth look at how the Gulf
views Corporate Governance
pages 33-42

The Importance of
Subsidiary Governance
Four perspectives on
on the latest regional trend
pages 10-23
The financial crisis has spawned a period of extraordinary activity in the field of regulation. Much of this involves rule-making, designed to make banks and other companies safer so that they will no longer be at risk of imposing shocks on the economy and needing government rescue. Some, however, aims to make companies work better.

Narrative reporting, which has recently attracted the attention of policy-makers, falls basically into this second category. While the European Union and British government are drawing up new rules, on the other side of the Atlantic, the US accounting authorities are looking at consistent standards. Meanwhile, the International Integrated Reporting Council, a wide-ranging coalition of dedicated practitioners, has come up with some radical new thinking on how companies should present their affairs.

While the proposed regulations are directed primarily at listed companies, they are worth consideration by private companies, too. Essentially they require companies to describe what they are doing, the risks and opportunities they embrace, and how that shapes both their results and their impact on the broader community. This exercise is a good one for any board because it requires directors to think carefully what their company is all about. Companies whose boards have understood this and can articulate their purpose are likely to be better run.

This is called narrative reporting because it complements in words the numbers that go into the annual report. The numbers are fine but they don’t mean very much without some explanation of how we got there. Thus, at the heart of the debate about narrative reporting, is the description of the business model. The numbers tell us what the profit is, but the words around the business model tell us how it is made.

Many years ago, when I was a financial journalist I remember being told by Sir John Egan, then Chief Executive of the company that ran London airport, that just being in the airport business was not really the point. His company sought to create value by understanding retailing – a large part of most airports is in effect a shopping mall – and understanding how to build well and cheaply so that he could roll out new airports anywhere in the world in an era of global privatisation.

What he was describing was his business model. He had identified the particular factors that helped his company create value and was shaping a strategy around them. The business model is what makes a company unique, and, if it is a good one, helps it to compete. It is different from strategic vision. For example, Sir John might have told me that he wanted to become the largest airport operator in the world within ten years. But that would not be a business model because he would not have been telling me how he was going to get there and why his company was uniquely placed to do so.

Many companies and boards have only a rather vague idea of what their business model really is. Being obliged to describe it under the new approach to narrative reporting will concentrate their minds. As the board comes to understand the business better, so directors will be more confident in how their company is managed.

If the business model is a description of what the company sees as its opportunity, then a description of the business model leads on naturally to consideration of risk, which is the obverse of opportunity. Understanding their business model will help companies understand better the risks they are running. Narrative reporting requirements which oblige them to disclose these risks will help them set the right priorities for dealing with them.

Up till now requirements on companies to disclose the principal risks and uncertainties they are facing has led to an unsatisfactory lawyer-driven result in which every...
The International Integrated Reporting Council is a global coalition of companies, investors, regulators, accountants, NGOs and standard setters. Chaired by Professor Mervyn King of South Africa who is a leading voice on corporate governance there, it aims to develop a reporting framework that will look at how companies create value from all relevant angles.

Companies are urged to develop a single cohesive report covering both financial and non-financial aspects of their business in a way that clearly shows the relationship between the two. This means reporting on all the inputs that go into their product and how they use them to create value. Such inputs would include not just financial capital, but human capital as well as other things, on which companies depend, like environmental resources and infrastructure. They are asked also to report on the outcomes of their activity in all these areas from a similarly broad perspective.

Currently the IIRC is consulting on its proposed framework, though it is not clear widely accepted it will be and how it will relate to existing reporting standards. After the consultation, the IIRC will refine the framework and produce a final version in December this year. Meanwhile a number of companies, including Microsoft and Prudential Financial are running pilot projects.

Even at this experimental stage, however, the key concept which the IIRC is promoting – connectivity – is gaining resonance among those who think about how companies work. To have a sustainable business a company must be in synch with the society from which it derives its franchise. So it must understand how a range of critical relationships work and be able to demonstrate this understanding to its stakeholders.
We have only just begun to explore these connections, but they matter both for healthy companies and our long term economic future. It is important, however, to see them in the context of value-creation. Understanding and managing non-financial risks is done is critical to the generation of value. This is not about having standards imposed from outside. It is something that comes from within.

The European Commission has produced a set of proposals requiring larger companies to report in greater detail on environmental aspects, social and employee related matters, respect for human rights, anti-corruption and bribery issues, and diversity on the boards of companies. The proposals are still in draft form and must be agreed by both the European Parliament and Member States before they become law.

Though the Commission says there is flexibility in the way the rules will operate, they are in fact quite prescriptive and differ in two ways from the approach of the IIRC. First, the Commission has specified the areas on which companies should report. This is regardless of their particular relevance. Thus it may not be necessary for a software company to report on its environment impact, but it will still have to explain why it does not do so in its annual report.

Second, the Commission has dropped its previous emphasis on materiality except with regard to any key performance indicators the companies may use to measure what they do.

The European approach is thus divorced from a description of value creation. It reflects a political view that companies have a social responsibility to report on matters of general public interest. This is a perfectly legitimate point of view, but the resulting reports are less likely to be of value from a governance perspective.