



## Financial Reporting Council

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6 December 2011

A handwritten signature in black ink that reads 'Dew Mark,' with a flourish at the end.

### **The Future of Narrative Reporting: Consulting on a new reporting framework**

I enclose the FRC's response to the Department's consultation on the future of narrative reporting. This letter highlights our key views and the issues that we are, and continue to, consider together as we take forward the narrative reporting agenda.

The FRC very much supports the principle of moving to a more streamlined and coherent framework for narrative reporting and the concept of having a concise Strategic Report, underpinned by a more detailed Annual Directors' Statement (ADS). However, as highlighted in the comments below and in the attached responses to individual questions, we have some concerns as to whether the proposals in the consultation paper will achieve the commitment given in the Government's March 2011 'Plan for Growth' to 'materially simplify narrative reporting for quoted companies'.

That said, given the importance we continue to attach to narrative reporting, most recently evidenced by the proposals on narrative reporting set out in the FRC's September 2011 report 'Effective Company Stewardship - Next Steps', we will continue to work closely with BIS, and other parties, to ensure that a "robust and future-proof framework is in place before implementation" (paragraph 1.18 of the consultation document).

On future-proofing, we agree that there is a need for BIS to continue to consider the wider context and developments in narrative reporting. But the continuing steady stream of new initiatives in this area makes this particularly challenging, for example:

- in the UK context, as well as proposing new provisions on reporting human rights issues and gender diversity in the boardroom, the document also refers to forthcoming potential additional disclosures on greenhouse gas emissions and corporate environmental impacts;
- in the European Union, the European Commission's 'responsible business package' (announced on 25 October) contains a number of elements that could impact on the proposals in the consultation document. In particular, the proposed amendments to the Transparency Directive include a provision for the European Securities and Markets Authority (ESMA) to issue guidelines to issuers "including standard forms or templates, to specify the information to be included in the management report". In our view, that runs the risk of undermining the intention in the consultation paper to keep the level of prescription of detailed content and format for the Strategic Report to a minimum.

In addition, we will need to consider how the proposals for Country-by-Country Reporting by extractive and forestry companies will fit into the structure and to work together to monitor and influence the Commission as it develops its legislative proposal on non-financial information to be disclosed by companies; and

- in the wider international context, the work of the International Integrated Reporting Committee (IIRC), which is currently consulting on a proposed framework for Integrated Reporting (IR). While IR is more an issue for the medium to long term, the IIRC's proposals are attracting a good deal of interest around the world and we should continue to monitor their progress.

In developing the proposals, there is a need to guard against complexity and clutter, which as you know has been a particular focus of the FRC's work in the last couple of years. We remain concerned that the requirements for the ADS to be the repository for reporting requirements irrespective of materiality could simply add to clutter and drive compliance-led reporting, rather than anything more meaningful and useful.

This is demonstrated in particular by the proposals on remuneration reporting. The FRC supports the principle that there needs to be "more direct and useful reporting on pay" which demonstrates how executive remuneration is linked to the company's strategy, performance indicators, risks and corporate governance arrangements. But we are concerned as to whether the proposals in section 5 will achieve that. A "standard format for reporting on remuneration within the Strategic Report" runs

the risk of resulting in boiler-plate, compliance driven reporting, rather than the flexibility for companies to "tell their story" as advocated in paragraph 2.12. Also, we question how remuneration reporting is being "slimmed down" (paragraph 5.8) if details are simply being moved into the ADS. In our view, this is an area to which particular attention needs to be devoted in developing final proposals.

Should you have any queries on this response please do not hesitate to contact me or David Loweth on 020 7492 2420.

*Yours sincerely,*

*Stephen Haddrill*

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**The future of narrative reporting: consulting on a new reporting framework. Response form**

**Please send your response by: 25 Nov 2011**

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I am responding on behalf of (please tick)	
<input type="checkbox"/>	<b>Yourself : Quoted company</b>
<input type="checkbox"/>	<b>Other company</b>
<input type="checkbox"/>	<b>Investor or investment manager</b>
<input type="checkbox"/>	<b>Business representative organisation</b>
<input type="checkbox"/>	<b>Investor representative organisation</b>
<input type="checkbox"/>	<b>Non governmental organisation (NGO)</b>
<input type="checkbox"/>	<b>Trade Union</b>
<input type="checkbox"/>	<b>Lawyer or accountant</b>
<input checked="" type="checkbox"/>	<b>Other (e.g. consultant or private individual)</b> <i>Regulator</i>

## Questions

### Question 1

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

Yes	No
√	
Comments	
In principle, yes, but please see our comments in covering letter.	

### Question 2

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?

Yes	No
√	
Comments	
<p>The FRC agrees, although we also think that the Strategic Report should also refer to the inclusion of key information on corporate governance (in line with the reference made in Figure 1 on page 16 of the consultation paper), in particular the report of the audit committee (see Question 4) and where a company is offering an explanation for non-compliance with the Corporate Governance Code. The FRC's publication 'Cutting Clutter: Combatting Clutter in Annual Reports' suggested a possible model.</p>	

While we agree with the inclusion of the first three bullet points in the list in the question, we would note that they are all, in fact, legal requirements flowing from the provisions on the management report contained in the current EU Accounting Directives (Article 46 of the 4<sup>th</sup> Directive and Article 36 of the 7<sup>th</sup> Directive).

Reporting on principal risks and uncertainties is of particular importance. In recent years, the FRC and its Operating Bodies (the ASB and the FRRP) have highlighted concerns about the quality of reporting of principal risks and uncertainties. In our September 2011 document 'Effective Company Stewardship - Next Steps', we noted that:

"The FRC has concluded that in future narrative reports, companies should:

- focus primarily on strategic risks - rather than those risks that arise naturally and without action by the company (such as volcanic interruptions of air travel or earthquake damage); and
- disclose these risks and the major operational risks inherent in their business model and their strategy for implementing that business model, explaining how they will address those risks and any obstacles that may be encountered as a result of changes in the business environment.

The FRC considers this would be more consistent with directors' legal duty to focus on the principal risks and uncertainties facing the company, rather than producing indiscriminate lists of all the risks companies face.

The FRC believes that any description of the risks a company faces should not be made difficult to assess by being scattered about the annual report. Consequently, if a company considers that the risks it faces are best understood if discussed in the context of the company's strategy, those risks should also be included in the company's description of principal risks in the Business Review (section 417, Companies Act 2006)".

The FRC agrees with the proposals to include information on strategy and the business model. There is a provision already included in the UK Corporate Governance Code (C.1.2) that "The directors should include in the annual report an explanation of the basis on which the company generates or preserves value over the longer term (the business model) and the strategy for delivering the objectives of the company". As noted in the quote above, there is a need to focus risk reporting around the description of the business model and the priorities that flow from that.

Reporting on environmental, employee and social and community matters “to the extent necessary for an understanding of the company’s development, performance or position” again reflects provisions within the EU Accounting Directives. There is also a need to closely monitor European Commission’s Corporate Social Responsibility (CSR) agenda in this area, which we know is intended to result in further legislative proposals in early 2012.

We agree in principle with the inclusion of information on key remuneration, but please see our comments in the covering letter.

**Question 3**

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

Yes	No
√	
Comments	
<p>Yes, but any final provisions need to make it clear that the Strategic Report covers both the narrative review and the relevant summary financial information, the requirements for which are currently set out in Statutory Instrument (SI) 2008/374 ‘The Companies (Summary Financial Statement) Regulations 2008’.</p>	

**Question 4**

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

Yes	No
	√
Comments	
<p>The FRC believes that, as set out in the January 2011 consultation on ‘Effective Company Stewardship’, directors should take collective responsibility for the content of the annual report (including the Strategic Report) and should make a statement affirming that responsibility.</p>	

The FRC does not agree that the Strategic Report should be signed off by each director individually. This is a mechanistic process that would not necessarily lead to directors becoming more engaged in determining the content of the annual report.

The FRC believes that our proposals on an enhanced role for audit committees, as set out in 'Effective Company Stewardship - Next Steps' could provide a better, and more practical, basis for getting the necessary board engagement.

In that document, we propose that the remit of the audit committee should be extended to include consideration of the complete annual report with a view to determining whether it is fair and balanced and provides the information necessary for shareholders and other users to assess the performance and prospects of the company. The audit committee would report to the full board on its assessment, and on how it has carried out its other responsibilities. Once this report has been approved by the board, it would be published in the annual report either as a report from the audit committee or the board (at the board's discretion).

The FRC proposes to consult in early 2012 on whether to amend the UK Corporate Governance Code to give effect to these proposals, and would welcome an early discussion with the Department to ensure a consistent approach is taken.

### Question 5

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)?

Yes	No
√	

Comments
<p>While the FRC agrees in principle, we believe that there is a danger that the ADS will become a 'dumping ground' for all sorts of disclosures, with 'boiler-plate', compliance-driven disclosure. While the Strategic Report is prepared specifically for shareholders, it appears that the ADS is to be prepared for a wider range of users. For example, paragraph 3.23 of the consultation document refers to a "significant number of users" requiring more detailed specific information on aspects of company performance or governance "that are not material to the company as a whole".</p> <p>As noted in our answer to question 2, we also believe that key corporate governance information should be included in the Strategic Report.</p>

**Question 6**

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	No
√	
Comments	

**Question 7**

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	No
√	
Comments	
<p>This links to the FRC's proposals for the role of the audit committee, as highlighted in the answer to question 4 above.</p>	

### Question 8

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

Yes	No
√	
Comments	

### Question 9

Do you support removal of the disclosure requirements, arising from company law, identified in Table 1? If not, please provide evidence of their relevance to users, including why disclosure in the Annual Directors' Statement is necessary for meeting their needs.

Are there any other disclosure requirements arising from company law that in your view could be simplified or removed?

Yes	No
√	
Comments	
<p>The simplification and/or removal of complex or unnecessary disclosures has been, and remains, a theme of the FRC's work on 'Cutting Clutter'. We note the proposal, outlined in paragraph 4.4 of the consultation document, that BIS will work closely with the FSA over the coming months to examine whether the disclosure requirements in company law, IFRS and the Listing and Disclosure and Transparency Rules are consistent. The FRC would welcome the opportunity to participate in this work. As well as the FRC taking forward the concept of the financial reporting lab, the ASB is also working with EFRAG and the ANC (the French accounting standard-setter) on a framework for disclosures in the notes to the financial statements, and both these initiatives should provide helpful input to the exercise.</p> <p>One caveat to note is that many disclosure requirements stem from EU legislation. While we welcome the Government's commitment (stated in paragraph 4.5) to work with European partners to ensure that the legal framework in this area is as consistent, effective and user-friendly as possible, delivering tangible results may prove to be challenging, as evidenced by the proposals issued by the European Commission as part of its responsible business package on 25 October.</p>	

### Question 10

Are there areas where the Listing Rules, IFRS, company law and the Corporate Governance Code are inconsistent or require similar disclosures? If so, how could these best be resolved?

Yes	No
√	
Comments	
<p>We have not undertaken a review of the disclosures in the sources referred to above, but we are aware that there are overlapping provisions, as the FRC highlighted back in June 2009 in the Discussion Paper 'Louder than Words: principles and actions for making corporate reports less complex and more relevant', in areas such as remuneration and related party transactions. As noted above in response to question 9, the planned review in this area should identify where overlaps and inconsistencies exist, together with proposals as to how they might be tackled and resolved.</p>	

### Question 11

Should quoted companies be explicitly required to include information about human rights (to the extent necessary for an understanding of the development, performance or position of the company's business) in the Strategic Report?

Yes	No
√	
Comments	
<p>The UK Government has already given its support to the UN Guiding Principles on Business and Human Rights (the 'Ruggie' framework), including provisions relating to the corporate responsibility to respect human rights. The European Commission has also expressed its support for the Ruggie framework in its 25 October Communication on a renewed strategy for Corporate Social Responsibility and signalled its view that it expects all European enterprises to meet the corporate responsibility to respect human rights, as defined in the UN Guiding Principles.</p>	

The Ruggie framework includes a principle (number 16) that business enterprises should express their commitment to meet their responsibility to respect human rights through a publicly available statement of policy and a further provision (21) to communicate externally how they address their human rights impacts. The Ruggie document notes that formal reporting by enterprises is expected where risks of severe human rights impacts exist. In our view, the requirement on what companies should disclose in their Strategic Report should reflect the wording in the Ruggie document, so that disclosure of such risks is required whether or not the information is necessary for an understanding of the development, performance or position of the company's business.

### Question 12

Do you support the Government's proposals for company disclosure of the proportion of women on boards and in companies as a whole?

Yes	No
√	
Comments	
<p>This fits with the FRC's work on board diversity.</p> <p>In May 2011 the FRC issued a consultation document seeking views on whether the Code should be revised as recommended by Lord Davies of Abersoch in his review of the gender diversity of the boards of UK-listed companies published in February 2011. The vast majority of respondents supported the amendments proposed.</p> <p>On 11 October, the FRC announced its decision to amend the UK Corporate Governance Code to strengthen the principle on boardroom diversity which was first introduced into the Code in June 2010. The amendments will require listed companies to report annually on their boardroom diversity policy, including gender, and on any measurable objectives that the board has set for implementing the policy and the progress it had made in achieving the objectives. The FRC will also update the Code to include the diversity of the board, including gender, as one of the factors to be considered when evaluating its effectiveness. The new provisions on diversity will apply to financial years beginning on or after 1 October 2012, at the same time as the proposed regulations, but earlier reporting is encouraged.</p>	

### Question 13

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?

Yes	No
√	
Comments	
<p>While the FRC agrees, there certainly appear to be issues with companies that also have a US listing, as is acknowledged in the consultation document.</p> <p>While there seems to be no reason per se why the current UK liability regime should discourage meaningful forward-looking disclosure, discussing the future seems to be one of the trickier areas for companies, as highlighted in the ASB's 2009 review of narrative reporting 'Rising to the Challenge'.</p>	

### Question 14

Would improved understanding and awareness of the UK liability regime help encourage more meaningful, formal looking statements? Are there other activities or changes that the UK Government could make that you believe may be necessary?

Yes	No
√	
Comments	

### Question 15

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	No
√	
Comments	
<p>As noted in the covering letter, the FRC agrees that key information on remuneration should be included in the Strategic Report. However, we do not agree with the proposal that such information should be given in a standard format. In our view, this could lead to boiler-plate disclosure which does not seem to fit the principle in paragraph 2.12 of the consultation document that the level of prescription of detailed content and format of the Strategic Report will be kept to a minimum.</p> <p>The Strategic Report should contain key details setting out how remuneration is aligned to the delivery of the business model and the management of risk as well as a single figure for the remuneration awarded to each director (see the answer to question 17 below). The Strategic Report should also include a section on the policy for the year ahead, but much of the rest of the data (including the performance data for the last five years) should be relegated to the Annual Directors Statement.</p>	

### Question 16

Which elements of the current disclosure requirements could be moved to the Annual Director's Statement, or removed entirely?

Yes	No
√	
Comments	
<p>The FRC has not undertaken a detailed review of the current disclosure requirements on remuneration, but we did highlight in the 2009 'Louder than Words' paper that remuneration reporting is prescribed by a number of different sources of regulation. There is a need to review and align these disclosure requirements where possible. It is not clear from section 5 of the consultation document the extent to which the key information proposed for the Strategic Report is intended to replace or add to existing disclosure</p>	

requirements. This is an area to which particular attention needs to be directed in developing the final proposals.

**Question 17**

Do you agree that quoted companies should be required to disclose the total remuneration of each director in a single cumulative figure?

If so, how should be calculated so that it accounts appropriately for the various elements of remuneration packages, including share options, LTIPs and pensions?

Yes	No
√	
Comments	
<p>The FRC would favour disclosure of a single figure for annual remuneration. The single figure should contain only elements which have been transferred during the year in question. This means it should include the net present value of any options or share incentives, rather than those from previous years which have vested or been encashed. Remuneration committees should explain how they have calculated the net present value of share-based compensation and confirm that the methodology is consistent from year to year.</p> <p>The consultation document notes that the disclosure of a single cumulative total awarded to each individual director is already a requirement in the USA, but without any reference to evidence as to usefulness of the figure to users. It would be useful to know if such evidence exists.</p>	

**Question 18**

Would there be benefits in introducing a requirement to disclose the pay of the highest earning executive officers below board level and, if so, to which companies and individuals should such an obligation be extended?

Are there alternative ways of improving shareholder oversight of the performance and pay of influential non-board executive officers?

Yes	No
Comments	
The FRC is not in a position to answer this question, which is really for comment by shareholders and other users.	

**Question 19**

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?

Yes	No
√	
Comments	

**Question 20**

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?

Yes	No
Comments	
As question 18.	

### Question 21

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?

Yes	No
√	
Comments	

### Question 22

Should quoted companies be required to provide estimates of the total future remuneration of executive directors if they exceed, meet or do not meet their performance criteria?

Yes	No
√	
Comments	

### Question 23

Should quoted companies be required to disclose the performance criteria for annual bonuses?

If so, should companies be permitted to delay the publication of commercially sensitive performance criteria for up to two years?

Yes	No
√	
Comments	
Performance criteria should be disclosed in the sense that they may relate to cash generation, margin improvement or whatever fits with the strategy but precise targets should not be disclosed as this is market sensitive. When the company reports on bonuses it has awarded it should state how the company has performed against these yardsticks.	

**Question 24**

Would disclosure by quoted companies of the ratio between the pay of the company's Chief Executive and the median earnings of the organisation's workforce provide useful information to shareholders?

If so, how should the ratio be calculated?

Yes	No
	√
Comments	
<p>While this is a question primarily for shareholders to answer, the FRC does not believe the ratio of CEO earnings to median pay is meaningful. By contrast, we believe that the rate of increase of CEO pay compared to the rate of increase of the overall company wage bill is meaningful. For that, of course, you need a single figure as outlined above in the answer to question 17.</p>	

**Question 25**

Do you agree that quoted companies should be required to disclose the total spend on directors' remuneration as a proportion of profit for the relevant financial year?

Yes	No
	√
Comments	
<p>The FRC is not convinced that this will provide meaningful information.</p>	

**Question 26**

Should the amount of fees paid by companies to remuneration consultants be disclosed, and is there any further information which should be disclosed by companies in relation to the procedure for setting directors' remuneration?

Yes	No
√	

Comments
<p>In the FRC's views, the existence of potential conflicts of interest on the part of remuneration consultants is a more relevant consideration than the scale of their fees. For this reason the FRC believes that any consultants who are involved in setting the remuneration of executive directors should be hired by the remuneration committee and fully responsible to it for all the services they provide to the company. The UK Corporate Governance Code already requires companies to disclose whether or not consultants have any other connection with the company.</p> <p>Remuneration committees should account for the way they have managed this relationship in the same way as audit committees account for the non-audit work provided by their auditor.</p>

**Question 27**

Do you agree that company law and the Listing Rule disclosure requirements on remuneration should be made fully consistent?

Yes	No
√	
Comments	
See answer to question 16 above.	

**Question 28**

Would reporting under International Financial Reporting Standards provide an appropriate basis for disclosure of remuneration in the preceding financial year if this were required on both an aggregate and individual basis?

Yes	No
√	
Comments	
This is linked to the answer to question 16 above, but if quoted companies are required to report under IFRS in any event, it would seem to make sense to use that reporting on remuneration in a wider context.	

### Question 29

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

If you support assurance beyond the consistency of the Strategic Report and the Annual Directors' Statement with the accounts, then please explain what you believe assurance should be provided on and the benefits that you believe will ensue.

Yes	No
√	
Comments	
The FRC's view on this is set out in our paper 'Effective Company Stewardship - Next Steps (section 5 in particular).	

### Question 30

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?

Yes	No
Comments	
The FRC looks forward to seeing the responses from constituents on this issue.	

### Question 31

Do you agree that the Audit Committee Report should contain, in addition to existing requirements:

- How long the current auditor has been in post; and when a tender was last conducted.
- The length of time since the directors, including members of the audit committee, have held discussions with principal shareholders about the company's relationship with its auditors, including the quality of service provided?

Yes	No
√	
Comments	
<p>Yes, subject to the need to align with the FRC in our follow up to Effective Company Stewardship – Next Steps’ (referred to in paragraph 6.13 of the consultation paper). The FRC’s ‘Guidance on Audit Committees’ already recommends that the audit committee report should include information on tendering frequency and the tenure of the incumbent auditor, but the current level of disclosure on these issues is disappointingly low.</p>	

### Question 32

The Government would also welcome views on the impact of these proposals, both on the cost of preparation of the Audit Committee Report, and of the benefits to investors of having access to this information.

Yes	No
Comments	
<p>See our answer to question 31. The FRC looks forward to seeing the responses from constituents on this issue.</p>	

### Question 33

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?

Yes	No
Comments	
Subject to the outcome of this consultation, the FRC stands ready to revise its existing guidance to provide guidance for the Strategic Report that accommodates the changes to the reporting framework and content.	

### Question 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.

Yes	No
√	
Comments	
The FRC believes that any proposed guidance should be at a 'framework' level, rather than include any degree of prescription, whether or not it is a voluntary statement or a mandatory standard.	

### Question 35

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?

Yes	No
√	
Comments	
We are content for the remit of the Panel to remain unchanged, but we would welcome discussions with BIS as to what steps the Government proposes taking to increase its profile and an understanding of its role.	