

Need to know

FRC publishes *Guidance on the Strategic Report*

In a nutshell

As a first step in the Financial Reporting Council's (FRC) new programme of work to promote clear and concise reporting, it has published ***Guidance on the Strategic Report***, a comprehensive publication designed to help companies prepare a strategic report that meets both the requirements of the law and the needs of shareholders. The FRC was asked by the Department for Business, Innovation and Skills (BIS) to prepare this guidance in the wake of the introduction of the revised legal framework for narrative reporting, which came into force for periods ending on or after 30 September 2013.

The guidance is a best practice statement rather than a mandatory reporting framework. As well as advice on the structure of the strategic report, the document also sets out the FRC's vision of the annual report and brings together into one document previously separate elements introduced by the FRC and BIS.

Although aimed mostly at quoted companies, for which the new regulations contain additional requirements, the guidance is still useful for unquoted companies as a source of best practice recommendations.

Reenergising narrative reporting – the 'clear and concise' programme

There is a general recognition that the lack of structure in some annual reports makes it harder for investors (the primary users of the annual report) to draw out the most critical content required to get an insight into the way the business is run, its strategic direction and its performance in the year. To combat this problem, as well as reflect its desire to 'cut the clutter' from corporate reports, BIS began a project in 2010 to reinvigorate narrative reporting for all UK companies. This project culminated in the approval by the UK parliament of a revised legal framework for narrative reporting in August 2013. Alongside the changes to the law, BIS also asked the FRC to prepare non-mandatory guidance supporting the strategic report requirements in the new regulations.

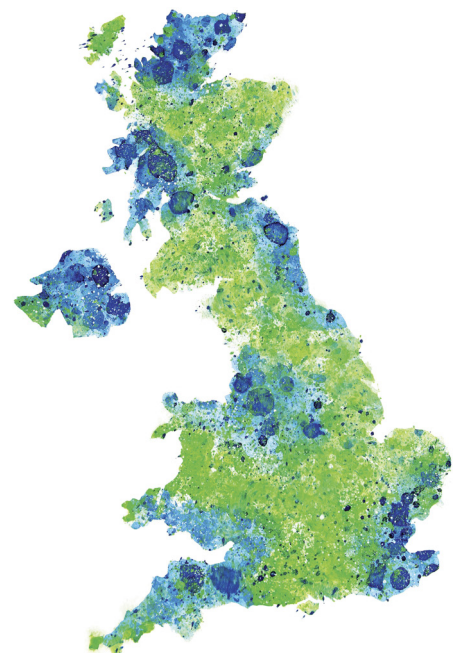
Shortly after the regulations were approved, the FRC published an exposure draft of this guidance to help early reporters. Having addressed the comments received on this considering the trends emerging from the first wave of companies complying with the new regulations, the Council has now published the final guidance as a first step in its new 'clear and concise' programme. The programme will comprise a series of initiatives over the coming year and beyond to encourage clearer reporting, focusing on what is material. Other initiatives will include publishing Financial Reporting Lab case studies setting out investor feedback on how well companies have addressed clarity and conciseness, and reporting by the Corporate Reporting Review team on reports where it commonly observes 'clutter'.

The annual report as a whole

As well as advising on its content, the guidance is intended to encourage preparers to consider how the strategic report fits within the annual report as a whole. It sets out a framework structure for the annual report but encourages companies to experiment, looking for innovative ways to link the various elements of the report together and create a more cohesive document. This is particularly relevant in relation to the newly effective requirement of the UK Corporate Governance Code 2012 that "the annual report and accounts, taken as a whole, is fair, balanced and understandable".

The guidance splits the structure into a number of separate yet interlinked components of an annual report, giving the objectives of each component, as well as linking the disclosure requirements of the Act, the Code and the Listing Rules to each component. Guidance is also given on the placement of information and the structure of components, as well as the use of cross-referencing and signposting. However, it also indicates that when designing an innovative structure for an annual report it is important to maintain clarity around the level of assurance that has been given over the information included.

As well as the FRC's guidance, we have also published our own ***Strategic Report – A practical guide***, available from www.ukaccountingplus.co.uk.



The guidance sets out objectives for each component, as follows:

Component	Component objectives
<i>Strategic Report</i>	<ul style="list-style-type: none"> To provide context for the related financial statements To provide insight into the entity's business model and its main objectives and strategies To describe the principal risks the entity faces and how they might affect future prospects To provide an analysis of the entity's past performance To provide signposting to show the location of supporting detail
<i>Corporate Governance Report</i>	<ul style="list-style-type: none"> To provide information necessary to explain how the composition and organisation of the entity's governance structures supports the achievement of the entity's objectives
<i>Directors' Remuneration Report</i>	<ul style="list-style-type: none"> To set out all elements of the entity's directors' remuneration policy and key factors that were taken into account in setting the policy To report on how the directors' remuneration policy has been implemented To set out amounts awarded to directors and provide details on the link between the entity's performance and directors' remuneration
<i>Financial Statements</i>	<ul style="list-style-type: none"> To present the entity's financial position, performance and development in accordance with Generally Accepted Accounting Practice
<i>Directors' Report</i>	<ul style="list-style-type: none"> To provide other statutory/regulatory information about the entity

Observation

Although the 'traditional' annual report structure presents these components as distinct sections, this is something that we have seen companies moving away from recently. Some examples from our most recent reporting surveys include presenting financial commentary (such as the FD's report) alongside the financial statements and presenting compliance-led narrative requirements (such as the remaining content of the directors' report) as part of the governance section or as an appendix to the report.

In addition, many companies continue to present additional sections such as a Chairman's statement.

The strategic report – high level guidance

The guidance on the strategic report itself is split into four subsections:

The first three of these give more general, high level guidance, with the discussion of content elements taking a detailed look at each of the requirements of the law.

A new beginning – Annual report insights 2013, our most recent comprehensive analysis of annual reporting, and *It has begun... the next wave*, our latest strategic report and 2012 Code implementation assessment, are both available from www.ukaccountingplus.co.uk.

Section 4 – The purpose of the strategic report

Section 4 sets out the overall objectives of the strategic report. As well as acknowledging that the strategic report should complement and supplement the financial statements, it also sets out three main content-related objectives:

- to provide insight into the entity's business model and its main strategies and objectives;
- to describe the principal risks the entity faces and how they might affect future prospects; and
- to provide shareholders with an analysis of the entity's past performance.

Section 6 – The strategic report: communication principles

Section 6 sets out overarching communication principles for the strategic report. In the view of the FRC, the strategic report should:

- be fair, balanced and understandable;
- be comprehensive but concise;
- be forward-looking, where appropriate;
- be entity-specific;
- highlight and explain linkages to the rest of the annual report;
- have its structure reviewed annually to ensure that it continues to meet its objectives efficiently and effectively; and
- have its content reviewed annually to ensure that it continues to be relevant.

Section 5 – The strategic report: materiality

Section 5 discusses the application of materiality in the context of the strategic report. Use of materiality is a key part of the quest to maintain brevity and understandability in narrative reporting, with the aim that both the strategic report and the annual report more broadly should only contain information that is relevant to shareholders.

The application of materiality to non-financial information is the subject of wide debate, due to the fact that a numerical 'significance test' cannot be used making this a much more difficult task than its application to financial information. In defining materiality in the context of the annual report, the FRC has tried to stick as close as possible to existing definitions – the guidance states that:

"Information is material in the context of the strategic report if its omission from or misrepresentation in the strategic report, could influence the economic decisions shareholders take on the basis of the annual report as a whole."

Qualitative factors will often have a greater influence on this determination of materiality than its application to the financial statements. In attempting to pin the concept down as far as possible, the guidance also makes a link between materiality and the terms 'key' (as in key performance indicator) and 'principal' (as in principal risks and uncertainties) used in the Act.

The guidance does clarify, however, that the concept of materiality cannot be applied to disclosures that are required by company law or its associated regulations unless explicitly allowed (for example, in the two cases discussed above). In addition, given the often diverse nature of the shareholder base of a quoted company, the directors must be careful to consider the needs of all significant shareholder groups when determining materiality.

The guidance also encourages preparers to follow these principles when drafting the annual report as a whole, not just the strategic report.

The strategic report – content elements

The guidance sets out three broad categories of content elements, most of which are drawn directly from the law as the FRC does not intend for the guidance to ‘gold-plate’ it with additional requirements. It does not envisage that these should be addressed in isolation by companies. The concept of ‘linkage’ features heavily throughout the guidance – in particular, the strategic report should highlight the numerous relationships and interdependencies between these elements of the strategic report and other disclosures in the annual report. A parallel can be drawn between this focus on the interdependency of elements and the holistic view of a business set out in the International Integrated Reporting Council’s (IIRC) Integrated Reporting (<IR>) framework, although the FRC does not specifically acknowledge this link in the guidance.

Strategic management How the entity intends to generate and preserve value	Environmental context The internal and external environment in which the entity operates	Business performance How the entity has developed and performed and its position at the year end
<ul style="list-style-type: none"> • Strategy and objectives • Business model 	<ul style="list-style-type: none"> • Trends and factors • Principal risks and uncertainties • Environmental, employee, social, community and human rights matters 	<ul style="list-style-type: none"> • Analysis of performance and position • Key performance indicators (KPIs) • Employee gender diversity

In its discussion of **strategic management**, the guidance indicates that the disclosure of an entity’s objectives, strategy and business model should together explain what an entity does and how and why it does it. This provides insight into its future development, performance and position, as well as how it generates or preserves value over the longer term and how it captures that value. Links between a business’ strategy and the key performance indicators that measure its success, or the principal risks that threaten it, are suggested as relationships that could be highlighted to help a company tell a coherent story.

Observation

Many companies choose to present their business model using a visual representation. This can make it easier to demonstrate the interrelationships between different elements, such as the inputs, outputs and business processes, giving shareholders a clearer picture of how the directors see the business as a whole.

When discussing **environmental context**, the guidance indicates that both internal and external factors that are likely to affect the future development, performance or position of the business should be considered. Many companies already present a market overview or similar section in their report, but as highlighted by the guidance it is particularly important to demonstrate the linkage between this and other areas of the strategic report given the influence this may have on them.

Likewise, linking principal risks and uncertainties to other areas (such as strategy) as well as providing information on the changes in risks, their likelihood and potential impact can all help to explain the context for the risks identified, making their relevance to the business clearer.

Since the original exposure draft, the FRC has updated the guidance around risks to take into account the changes to the Code around going concern which are currently being proposed. Risks or uncertainties that constitute a material uncertainty over the entity’s going concern status should be clearly identified, while others with potential effects of such a magnitude that they may threaten the entity’s longer-term viability (i.e. its solvency and/or liquidity) should be explained fully and given due prominence.

When discussing environmental matters, employee matters and social, community and human rights issues, the guidance specifies that such material should be included in the strategic report only when necessary for an understanding of the development, performance or position of the entity’s business. When this is the case, the information presented should make it clear how these matters might impact the business.

Our *Need to know on the <IR> framework*, published in December 2013, can be obtained from www.ukaccountingplus.co.uk.

Examples of how all of these linkage ideas can work in practice may be found in our *Strategic Report – A practical guide* and *A new beginning – Annual report insights 2013*, our most recent comprehensive analysis of annual reporting, both available from www.ukaccountingplus.co.uk.

A *Governance in brief* publication which sets out the details of the FRC’s latest consultation on changes to the Code can be obtained from www.ukaccountingplus.co.uk.

Observation

With companies coming under scrutiny for their wider business impact, many now prepare a separate corporate social responsibility (CSR) report distinct from the annual report. Nevertheless, it is still necessary to include such information in the strategic report as well when it is of strategic relevance – a cross-reference to a separate standalone CSR report on its own is not sufficient. On the other hand, it is important not to bring in too much detail – as pointed out by the FRC in the guidance, CSR information should only be included in the strategic report if it is material.

The entity's assessment of **business performance** should supplement the financial statements. This analysis should be provided in the context of the strategy applied by the entity during the financial year. In particular, the KPIs used in the discussion should be those that the directors judge are most effective in assessing progress against objectives or strategies, monitoring principal risks, or otherwise monitoring the development, performance or position of the business.

When presenting such measures, it is important to bear in mind their relationship and similarity to other measures used, such as alternative performance measures presented in the financial statements, measures used to assess executive remuneration and those reported to the chief operating decision maker and presented in the segmental analysis. These relationships should be made clear and differences reconciled.

Providing a standalone strategic report to shareholders

Under the new regulations, companies may provide shareholders with the strategic report and certain supplementary material rather than a copy of the full annual report. In recognition of this, the guidance includes some advice on compliance with the law in this area. It also contains advice for companies that wish to send non-statutory summarised business information to shareholders.

Observation

Companies that wish to take advantage of this option should also consider the completeness of the strategic report as a standalone document. For example, it is likely to be desirable to ensure that the strategic report contains some form of summarised financial information, given that an investor receiving only the strategic report will not necessarily have easy access to the financial statements. It will also create difficulties if the strategic report incorporates information included elsewhere in the annual report by cross-reference, as such information would also need to be included.

Deloitte view

Many companies have already implemented the new regulations for the first time. There has been an encouraging level of innovation and we expect this guidance to help companies on their journey to provide more holistic, meaningful annual reports.

The FRC guidance is a useful document for those who want to improve the quality of corporate reporting in a thoughtful manner. It draws together the elements of the strategic report with the wider annual report, including elements that have been introduced by both the FRC and BIS, and sets them all in context. The guidance also illustrates in a practical manner how the requirements can be approached, provides examples of how the various elements link together and helpfully suggests how to determine which disclosures might be material.

The guidance also helps to further align best practice in the UK with global initiatives aimed at improving corporate reporting, such as integrated reporting.

Further information

The FRC's *Guidance on the Strategic Report* can be downloaded from the FRC website.

The *Strategic Report – A practical guide* is a Deloitte publication designed to help businesses make their strategic reports as valuable for users as possible. As well as providing guidance on the key requirements of the existing and new legislation, it provides useful insights into what those requirements really mean and how they might be best approached in practice.

A new beginning – Annual report insights 2013, our most recent comprehensive analysis of annual reporting, looks at how companies were reporting in their final year under the old regulations and discusses the impact of the new legal requirements. Our 2014 version of this, which will look in detail at the first set of reports prepared under the new regulations, will be released in September 2014.

It has begun, a survey of the first companies reporting under the new regulations (September 2013 year-ends), is a publication looking at some of the potential pitfalls for companies when making this transition and some innovative ideas for restructuring narrative reporting. *It has begun... the next wave* follows on from this, looking at December 2013 year-ends from a similar perspective.

All of these publications are available from www.ukaccountingplus.co.uk, our dedicated UK financial reporting resource centre.

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