



Need to know

FRC publishes consultation on amendments to its Guidance on the Strategic Report

Contents

In a nutshell

Background

Overview of the proposed amendments to the Guidance

Section 2 – Scope

Section 4 – The purpose of the strategic report and section 172

Section 5 – Materiality

Section 6 – Communication principles

Section 7 – Content elements

Other proposed amendments

Further information

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www.ukaccountingplus.co.uk

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This edition of Need to know outlines proposed amendments to the FRC's Guidance on the Strategic Report.

In a nutshell

- The Financial Reporting Council (FRC) has published draft amendments to its Guidance on the Strategic Report.
- Companies are encouraged to consider the broader matters that may impact their business over the longer term, to the extent material to the shareholders.
- The updates:
 - enhance the link between the purpose of the strategic report and the matters directors should have regard to under section 172 of the Companies Act 2006 (s172); and
 - reflect the new disclosure requirements arising from the UK implementation of the EU Non-Financial Reporting Directive which are effective for periods beginning on or after 1 January 2017.
- The extent of new disclosure will vary by company as the scope of the Directive differs from that of the previous strategic report (e.g., it includes some unquoted companies).
- The Guidance remains non-mandatory with a view to encouraging best practice.
- The FRC is requesting comments by 24 October 2017.

Background

The FRC's Guidance on the Strategic Report (Guidance) is being amended to reflect developments in corporate reporting since the Guidance was first published. These include:

- the amended strategic report requirements (as set out in the Companies Act 2006 section 414CB) resulting from the UK implementation¹ of the EU NFR Directive². These amendments are effective for financial years beginning on or after 1 January 2017 and apply to certain large entities with more than 500 employees; and
- the Government's 2016 Corporate Governance Reform Green Paper. The FRC proposals help companies ensure their strategic reports meet its primary purpose – to inform members and help them to assess how directors have fulfilled their duty under s172 to consider broader stakeholders when taking decisions to promote the long term success of the company.

The FRC proposes further targeted improvements to the Guidance to reflect other important developments in corporate reporting, mainly in relation to the *ESMA Guidelines on Alternative Performance Measures*.

Overview of the proposed amendments to the Guidance

The most notable proposed amendments are to the following sections of the Guidance.

Section 2 – Scope

The Companies Act 2006 sets out different levels of reporting depending on the type of the company e.g., based on size, whether it is quoted, or traded, or a public-interest entity. A detailed analysis of the Act's requirements in respect of the strategic report, including information on the application of the statutory requirements to different types of entity, is set out in Appendix III of the Guidance and in our **Need to Know on the UK Non-Financial Reporting Regulations**. However, the Guidance does not differentiate on this basis and has been developed within the existing legislative framework for the strategic report.

The proposed amendment states that "It is best practice to disclose information that is necessary for an understanding of the development, performance, position or future prospects of the entity or the impact of its activity in the strategic report, irrespective of the existence or otherwise of an explicit statutory disclosure requirement".

The Guidance remains non-mandatory with a view to encouraging best practice.

Observation

Due to the way the EU NFR Directive has been implemented into UK law, there are two similar, but different, sets of requirements operating in parallel. Companies may need to comply with the strategic report requirements, the requirements of the EU NFR Directive, or both. This leads to complexity but was done to avoid 'gold-plating' of the EU NFR Directive.

The requirements of the EU NFR Directive are already effective. Entities need to pay attention to this and revisit the Guidance due to differences in scope and extent of non-financial reporting required. This process of revisiting and analysing and documenting would ideally be discussed with the Audit Committee.

Section 4 – The purpose of the strategic report and section 172

The proposed amendments aim to strengthen the link between the purpose of the strategic report and the matters directors should have regard to under s172. The purpose of the strategic report is to inform members of the company and to help them assess how directors have performed their duty to promote success of the company in the long term "for the benefit of members as a whole, while having regard to the matters set out in section 172".

1. Companies, Partnerships and Groups (Accounts and Non-Financial Reporting) Regulations 2016 (SI 2016/1245) (**Regulations**)

2. EU Directive on disclosure of non-financial and diversity information by large companies and groups (2014/95/EU) (**EU NFR Directive**)

Need to know

The proposed amendments state that “The success of a company is dependent on its ability to generate and preserve value” and that companies “need to build and maintain relationships with a range of stakeholders in order to generate and preserve” such value. It is further proposed that the strategic report should “include information relating to sources of value that have not been recognised in the financial statements and how those sources of value are managed, sustained and developed, for example a highly trained workforce, intellectual property or internally generated intangible assets, as these are relevant to an understanding of the entity’s development, performance, position or impact of its activity”.

Proposed amendments to Section 7 *The strategic report: content elements* of the Guidance include a number of encouraged content elements that go beyond the specific legal requirements, but can assist when considering how the strategic report meets its overall purpose.

Observation

Some companies have already started to acknowledge in their reports, more explicitly, the directors’ duty under s172, and seek to explain to investors how the duty has been fulfilled.

The amendments to this section seek to help reporters explain which factors drive the generation of value in the company and provide insight into whether boardroom decisions have taken wider stakeholder interests into account. Increasingly, it is appreciated that many of those factors are not on the balance sheet, for instance, relationships with broader stakeholders, intellectual property or a highly trained workforce, yet are crucial to the long term success of the organisation.

Section 5 – Materiality

The proposed amendments are aimed at enhancing the focus on non-financial information and long term value.

The proposed amendments emphasise that ‘providing information that is material for shareholders will also thereby provide information that is useful to all stakeholders taken as a whole. When determining whether information is material, an entity should consider whether the fact or circumstance would affect the ability of the entity to generate or preserve value in the long term.’

The proposed changes state specifically that “In the context of qualitative information in general and non-financial information in particular, a numerical materiality figure is of less importance and a separate assessment may be required”.

Further amendments include clarification and limitation of when the derogation from the general requirement to disclose information can be used.

Observation

The FRC has reconfirmed that the annual report is a document primarily for shareholders. The materiality of qualitative disclosures continues to be viewed through investors’ lens, taking into account the needs of all shareholder groups, including those who take a long term view. Only information that is material to shareholders should be placed in the annual report and any additional information that is provided to meet the needs of individual stakeholders should be placed elsewhere (e.g., online or in another report), where law or regulation permits.

Section 6 – Communication principles

The proposed amendments to Section 6 encourage companies to better integrate related information in their reports. It encourages entities to consider the most effective methods of communicating material information and placement of that information in the annual report. It emphasises the ability of shareholders to assess the factors that may impact the long term success of the business, which may involve looking beyond the strategic planning horizon.

Observation

The FRC is encouraging directors and companies to discuss the critical linkages between the company's business environment and business performance and how the directors and senior management provide the strategic direction for these activities.

Section 7 – Content elements

The proposed revisions to Section 7 strengthen the guidance relating to non-financial reporting to reflect changes arising from the EU NFR Directive. They encourage companies to consider the broader matters that may impact the value of the company over the longer term, particularly in relation to strategy and business model disclosures. Encouraged content elements have been included which, although not explicitly required, may help entities in ensuring the strategic report meets its overall purpose.

Some of the more significant amendments/additions to content elements include:

- reflecting the enhanced disclosures in respect of the environment, employees, social matters, respect for human rights, and anti-corruption and anti-bribery matters (where necessary for an understanding of the entity's development, performance and position and the impact of its activity). This includes considering the impact of the entity's business on these matters, where material to shareholders, and any principal risks relating to these matters;
- a focus on purpose, i.e., why the entity exists and how it intends to fulfil its purpose, thereby generating and preserving value;
- an explanation of values, behaviour and culture within the entity;
- how the entity engages with major stakeholders and takes their views into account when making significant decisions;
- the nature of resources and relationships on which the entity's success in the long term depends;
- a discussion of how the allocation of resources will support the achievement of the entity's strategy; and
- a discussion of how the business model and strategy might evolve in response to long term systemic risks e.g., risks arising from climate change.

These proposed amendments place greater emphasis on the notion of value generation and aim to encourage companies to consider how value is generated through the use of qualitative and quantitative disclosures. The FRC avoided providing prescriptive guidance to encourage entities to be innovative in this space and to develop an approach that is appropriate for their business.

Observation

The content elements are not limited to financial or monetary items, and encourage discussion of other sources of value not captured in the financial statements along with appropriate use of alternative performance measures, key performance indicators and other metrics, where those are used in running the business.

The requirements of the EU NFR Directive differ, in some respects, from the previous requirements of the strategic report as applicable to quoted companies. There are additional non-financial reporting matters to report on, including anti-corruption and bribery, and principal risks specifically related to those matters need to be considered. The updated Guidance will help entities review and refresh their principal risks in light of the enhanced requirements of the EU NFR Directive. This may result in entities including additional disclosure in respect of non-financial information.

Other proposed amendments

Other updates to the Guidance also include targeted improvements to reflect recent developments in corporate reporting, mainly the *ESMA Guidelines on Alternative Performance Measures*.

Observation

We welcome the FRC's exposure draft of the amendments to the Guidance on the Strategic Report as a useful and accessible document which illustrates, in a practical manner, how preparers can navigate the various regulatory and other emerging developments in the UK narrative reporting landscape to provide fair, balanced and comprehensive information to shareholders.

Further information

If you have any questions about the subject raised in this publication, please speak to your normal Deloitte contact. More information on UK corporate reporting, as well as other UK accounting and corporate governance news and publications, can be found at www.ukaccountingplus.co.uk/

FRC's Draft amendments to Guidance on the Strategic Report

Need to Know on the EU Non-Financial Reporting Directive Guidelines

Need to Know on the UK Non-Financial Reporting Regulations

Need to Know on Alternative performance measures: A practical guide



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