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Need to know

FRC's revised Guidance on the Strategic Report

Contents

- The Financial Reporting Council's (the FRC) revised Guidance on the Strategic Report, published in July 2018, encourages companies to consider wider stakeholders and broader matters that impact performance over the longer term.
- The Guidance places a greater focus on the directors' duty to promote the success of the company under section 172 of the Companies Act 2006. In particular, it reflects a stronger link between the purpose of the strategic report and the matters directors should have regard to under section 172.
- Large companies (whether quoted or not) from 1 January 2019 will need to disclose a "section 172(1) statement". The FRC's Guidance includes a new section in relation to this new requirement.
- The Guidance has also been enhanced to recognise the increasing focus on non-financial reporting, including the impact of the Non-Financial Reporting Directive. In particular, it clarifies that the FRC expects a separate non-financial information statement to be included in the strategic report of those companies in scope of the Non-Financial Reporting Directive (s414CB).
- The Guidance remains non-mandatory with a view to encouraging best practice.

Background

In July 2018 the Financial Reporting Council (the FRC) published its revised Guidance on the Strategic Report (the Guidance), following a consultation in 2017. The Guidance is a comprehensive publication designed to help companies prepare a strategic report that meets the requirements of the law including the requirement for all large companies to include a new "section 172(1) statement". The revised Guidance helps companies ensure their strategic reports meet their 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 – as well as providing a new section of guidance that addresses the section 172(1) statement.

For further information on the FRC Guidance please see our Need to know which was published when the original Guidance was issued.

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Section 172(1) of the Companies Act 2006 states that:
A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to:

- *the likely consequences of any decision in the long term;*
- *the interests of the company's employees;*
- *the need to foster the company's business relationships with suppliers, customers and others;*
- *the impact of the company's operations on the community and the environment;*
- *the desirability of the company maintaining a reputation for high standards of business conduct; and*
- *the need to act fairly as between members of the company.*

Further targeted improvements to the Guidance have been made to reflect the UK implementation of the EU Non-Financial Reporting Directive (NFR Directive) and other developments, for example, the ESMA Guidelines on Alternative Performance Measures.

Overview of the amendments to the Guidance

Section 2–Scope

There have been some changes to the scope of the Guidance.

1. 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. Given the complexity of the reporting regime, a new section has been included within the scope of the Guidance to summarise the content elements of the strategic report for different entities. It also includes a useful flow chart to assist preparers in identifying the relevant sections of the Guidance (paragraph 2.7).

   A more 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 II of the Guidance and in our Need to Know on the UK Non-Financial Reporting Regulations.

2. The original version of the Guidance was written with the requirements for quoted companies in mind, although it represented best practice for all companies required to prepare a strategic report. The amendments clarify that the Guidance covers the entire range of entities that are required to prepare a strategic report and therefore should be applied proportionately (paragraph 2.4).

3. The Guidance now addresses more explicitly disclosure of non-financial information, stating in paragraph 2.2 "As a general principle, this guidance encourages disclosure of material financial and non-financial information that is necessary for an understanding of the development, performance, position or future prospects of the entity in the strategic report".

Section 4 – The purpose of the strategic report

The Guidance reflects a stronger link between the purpose of the strategic report and the matters directors should have regard to under s172[1]. As a reminder, 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".

The main content-related objectives of the strategic report identified in the Guidance have been expanded from three to five, which are:

a) to provide insight into the entity's business model and its main strategy and objectives;

b) to describe the principal risks the entity faces and how they might affect its future prospects;

c) to provide relevant non-financial information;

d) to provide an analysis of the entity's past performance; and

e) to provide information to enable shareholders to assess how directors have had regard to stakeholders and other matters when performing their duty under section 172.

Parts (c) and (e) are new, reflecting the recent developments in corporate reporting.

The original Guidance stated that additional explanations of amounts recognised in the financial statements should be provided in the strategic report, alongside explanations of the conditions and events that shaped the information contained in the financial statements. This has now been expanded to include discussion of key elements in the entity's business model that are not reflected in the financial statements. Specifically, 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. The Guidance includes examples of such sources of value (a highly trained or experienced workforce, natural capital, intellectual property or intangible assets) and describes them as being "relevant to an understanding of the entity's development, performance, position or future prospects" (paragraph 4.5).

The theme of value creation continues, with paragraph 4.6 stating "The success of a company is dependent on its ability to generate and preserve value over the longer term. Companies do not exist in isolation; they need to build and maintain relationships with a range of stakeholders in order to generate and preserve value."

Observation

This section highlights the role of the strategic report as providing essential context to the financial statements and the fact that there should be consistency between the strategic report and the financial statements.

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 recognised that many of those factors are not included in company balance sheets, for instance relationships with broader stakeholders, intellectual property or a highly trained workforce, yet are crucial to the long term success of the organisation.

1. https://www.legislation.gov.uk/ukpga/2006/46/section/172

Section 5 – Materiality

This section of the Guidance discusses the application of materiality in the context of the strategic report and highlights that qualitative factors may often have a greater influence on the determination of materiality in the context of the strategic report, particularly in relation to non-financial information. A new paragraph, paragraph 5.5, has been inserted which encourages directors to 'consider the significance of the matter relative to the entity's business model and strategy' when determining whether a matter is material for the strategic report. The example it provides is 'when considering if information on the impact of an entity's activities on the environment is material, the directors should consider the implications for the company's long-term value generation arising from stakeholder, legal or regulatory responses'.

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 other individual stakeholders should be placed elsewhere (e.g., online or in another report), where law or regulation permits.

Section 6 – Communication principles

Few amendments were made to this section of the Guidance which sets out overarching communication principles for the strategic report. A new paragraph 6.2 encourages entities to consider the most effective methods of communicating material information and placement of that information in the annual report, while paragraph 6.14 brings in the section 172(1) theme of providing information that would enable shareholders to assess the factors that may impact the long term success of the business (see section 8, below).

The two linkage examples in this section have been updated. While the underlying message of communicating a joined-up story remains the same, the attention of these linkage examples has changed such that they now focus more on the link between company performance and other aspects of the report (notably principal risks and directors' remuneration).

Section 7 – Content elements

The content requirements for the strategic report are set out in sections 414C *Contents of the strategic report*, 414CB *Contents of the non-financial information statement* and 414CZA *Section 172(1) statement* of the Companies Act 2006. The requirements vary depending on size and type of entity.

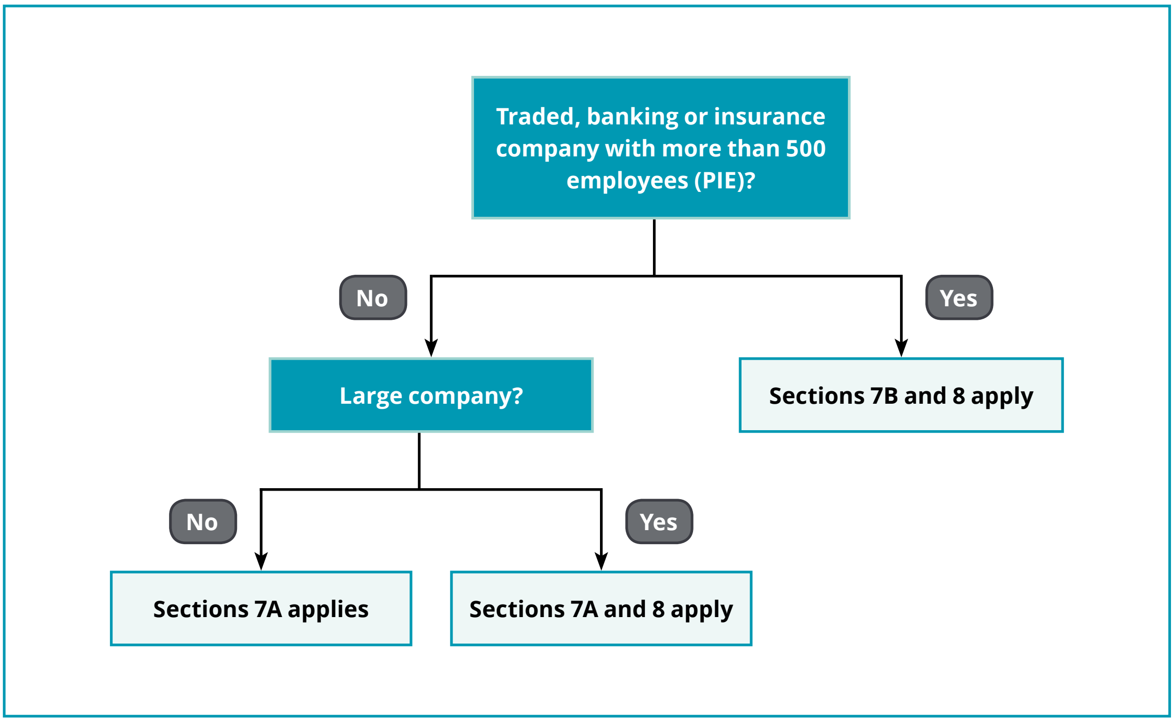
Section 7 of the Guidance has been restructured into two parts to help preparers navigate the various reporting requirements:

- Part 7A contains all the strategic report content requirements set out in section 414C of the Act that apply to companies (quoted or unquoted) that do not fall within the scope of the NFR Directive (see chart below).

- Part 7B applies to PIEs (broadly traded, banking or insurance companies) with more than 500 employees (whether quoted or unquoted) that are therefore in scope of the NFR Directive (see Need to know: Non-financial Reporting Regulations). It contains all of the relevant guidance from 7A as well as the requirements of section 414CB (which reflect the NFR Directive disclosure requirements).

In both of these sections, those requirements which are only applicable to quoted companies are clearly identified by use of an icon in the margin.

This useful diagram from the Guidance helps companies determine which parts of the Guidance are applicable.



The Guidance has been updated and enhanced to support a longer term perspective on companies' strategy and performance. None of these changes should be new to those following the spirit of the original Guidance. Some of the key changes are:

- an explanation of purpose, i.e., why the entity exists and how it intends to fulfil its purpose, thereby generating and preserving value (paragraph 7A.8);
- an explanation of values, behaviour and culture within the entity so that the company purpose can be put into context (paragraph 7A.10);
- the nature of resources and relationships on which the entity's success in the long term depends, including a focus on those resources and relationships that have not been reflected in the financial statements because they do not meet the criteria for recognition as assets (paragraph 7A.16);
- a discussion of how the business model and strategy might evolve in response to long term systemic risks which could have a material effect on the entity's long term prospects, e.g. risks arising from climate change (paragraph 7A.31);
- emphasising that performance measures should support an assessment of the entity's progress against its strategy and objectives. There should be alignment between the performance measures presented in the strategic report and the key sources of value and risks identified in the business model. In particular, non-financial performance measures may be a mixture of indicators which provide information about what the company has done in the past and what may happen in the future; they should include matters potentially affecting the long-term sustainability of the entity (paragraphs 7A.69-70);
- the consideration of the main trends and factors likely to affect the future development, performance and position of the entity's business; the Guidance has been expanded to include consideration of both the trends in the market in which the entity operates and the trends and factors relating to society more generally. For instance, an entity should consider the risks and opportunities arising from factors such as climate change and the environment, and where material, discuss the effect of these trends on the entity's future business model and strategy (paragraph 7A.22); and

- the information about environmental matters, employees, social and community issues and human rights issues should assist shareholders in assessing an entity's ability to generate and preserve value over the long term; it should also help assess the management of risks which may impact the sustainability of the entity's business or may affect society more broadly in ways which are not reflected in the financial statements. The guidance in this area has been substantially rewritten and lists a number of factors to consider when determining the appropriate level of information to disclose (paragraphs 7A.36-42).

  As well as including the guidance from Section A that applies to PIEs, **Section 7B** includes new guidance, addressing the disclosure requirements of the NFR Directive 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. Specific new guidance includes:

- encouraging companies to look beyond their own operations and consider how risks and impacts arising from business relationships, products and services, affect their principal risks. For instance, a company could consider the reputational risk arising from factors such as poor labour practices in its supply chain or purchasing products which have been produced in a manner which has a significant environmental or ecological impact (paragraph 7B.34);

- providing information to enable users to understand the impact of activities on the business, on stakeholders and society, focusing on those matters which could affect the long-term success of the company. These impacts may pose threats, opportunities and may be positive or negative (paragraphs 7B.43-45);

- a description of any due diligence processes over policies relating to material matters to ensure the policies are adhered to throughout the group, and, where appropriate, through its supply chain. Due diligence processes should be company specific and boilerplate disclosures are of limited use (paragraphs 7B.52-55); and

- clarification that the non-financial information statement should be a separate statement in the strategic report and contain the information required by s414CB of the Act or include cross-references to where such information can be found in the main body of the strategic report (paragraphs 7B.82-84, Section 414CA(1) of the Act).

Observation

Due to the way the 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 NFR Directive, or both. This leads to complexity but was done to avoid 'gold plating' of the EU NFR Directive. The introduction of sections 7A and 7B help preparers to navigate the various sets of requirements.

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 managing the business. The emphasis is on value generation and encouraging companies to consider how value is generated through the use of qualitative and quantitative disclosures.

Section 8– Content elements for section 172(1) statement reporting

For reporting periods commencing on or after 1 January 2019, the *The Companies (Miscellaneous Reporting) Regulations 2018 (SI 2008/860)* require all large companies, irrespective of listing status, to include a "section 172(1) statement" in their strategic report. This describes how the directors have complied with their duty to promote the success of the company for the benefit of its members whilst having regard to the matters set out in section 172(1) (a) to (f) (see above):

Companies within scope must make their section 172(1) statement available on a website, free of charge, and ensure it remains available until the statement for the next financial year is made available.

Please see our Need to know on *The Companies (Miscellaneous Reporting) Regulations 2018 (SI 2008/860)* for more detail.

The information contained in a section 172(1) statement will depend on the individual circumstances of each company, but companies will probably want to include information on some or all of the following (paragraph 8.11):

- the issues, factors and stakeholders the directors consider relevant in complying with section 172(1) (a) to (f) and how they have formed that opinion;
- the main methods the directors have used to engage with stakeholders and to understand the issues to which they must have regard; and
- information on the effect of that regard on the company's decisions and strategies during the financial year.

The Guidance highlights the fact that there will be linkages and overlaps between information contained in the strategic report and that required to be included in the section 172(1) statement. In order to avoid repetition and maintain the cohesion of the narrative contained within the strategic report, information should be incorporated into the section 172(1) statement by cross-reference where appropriate (paragraph 8.5).

A number of suggestions are made in the Guidance as to what may be included or referred to in the section 172(1) statement, including:

- linkage to risk management and principal decisions made to demonstrate having regard to likely consequences of decision-making in the long term;
- linkage to the business model when identifying key stakeholders and their importance to the long-term success of the company. This should include a broader consideration of who key stakeholders are other than those listed in s172(1), such as pensioners, pension schemes and their entire workforce (which is broader than considering simply employees);
- demonstrating decision-making by identifying the principal decisions taken by the board during the year (such as determining capital allocation, including setting a dividend policy) and describing how the directors had regard to the matters in s172(1). In particular, detail could be given around specific decisions whereby the interests of one group of stakeholders was not aligned with the interests of other stakeholders or with the interests of shareholders, and how the directors considered the different interests and the factors taken into account in making that decision; and
- demonstrating how the directors have maintained the desired reputation for high standards of business conduct by linking to the Board's desired culture.

The Guidance also highlights the fact that the section 172(1) statement is not restricted to a group strategic report but must be prepared at an individual company level for all companies in scope. In practice, decisions and policies affecting employees, the environment, suppliers and other stakeholders will often be taken at group level. It is anticipated that subsidiary companies will be able to make cross-references to group statements and policies where appropriate, but should not assume that the matters covered in their parent company's statement are the same as those that apply to the subsidiary.

Observation
We welcome the FRC's updated Guidance 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, balance and comprehensive information to shareholders.

Further information

If you have any questions about the matters covered in this newsletter, please speak to your usual 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/

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 the Companies (Miscellaneous Reporting) Regulations 2018

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Need to Know on 2014 Guidance on the Strategic Report

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