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Governance *in brief*

FRC encourages broader reporting of company purpose and impact in proposed revisions to the Guidance on the Strategic Report

Headlines

- The FRC has published proposed revisions to its Guidance on the Strategic Report. These revisions encourage companies to report on broader matters that may impact the value and sustainability of business over the longer term. For example:
  - the entity's purpose and the impact of the entity's activities on society more widely;
  - information about the relationships that are most important to the entity's ability to generate and preserve value and how those relationships are taken into account in the boards' decision making; and
  - the values, behaviours and culture that it seeks to uphold.
- Addressing the current lack of reporting requirements around section 172 of the Companies Act (s172), the FRC clarifies and expands on the aims of the strategic report to help members of the company assess how directors have performed their duty to promote the success of the company in the long term, including how they have had regard to the matters set out in s172 (see over).
- The annual report remains as a document primarily for the shareholder but the proposed Guidance states that new reporting elements will be of interest to wider stakeholders. However, this is not to substitute for fuller communication with other stakeholders through different means.
- The FRC also highlights the role of the auditor who has a responsibility, based on the knowledge obtained in the course of the audit, to report on whether they have identified any material misstatements in the strategic report.
- This Guidance is relevant to all companies that prepare a strategic report, not just listed companies.

The FRC's approach to the update

The update has arisen from a need to:

- reflect new corporate reporting requirements arising from changes to the Companies Act 2006 which implement the EU Non-Financial Reporting Directive;
- enhance the linkage between s172 and the aims of the strategic report; and
- make targeted improvements to certain areas of the guidance to reflect recent key developments in corporate reporting.

In addition to helping companies to respond to a number of compliance initiatives, the updates the FRC are proposing help to put the strategic report at the forefront of reporting on how businesses create and generate value for society in the very broadest sense.

The FRC has previously encouraged reporting in respect of the directors' duty to promote the success of the business in the long term and broader stakeholder engagement under s172 in its regular updates on corporate reporting, including the 2016 Corporate Reporting Review annual report and in its regular letters to FTSE 350 Audit Committee Chairs and to investors. This updated Guidance formalises the FRC's expectations regarding s172 reporting and anticipates the Government's proposals to require all companies of significant size to explain how their directors comply with the requirements of s172 to have regard to employee and other interests. So this aspect of the Guidance will also be reflected in legislation in 2018.

Other changes relate to the EU Non-Financial Reporting Directive, which is effective in the UK for periods commencing on or after 1 January 2017. The scope of the changes is complex and applies to certain large entities, including all EEA PIEs, with more than 500 employees. A detailed table explaining the scope of the changes is available in our Need to Know: Non-Financial Reporting Regulations.

Finally, the update also reflects the new ESMA Guidelines on presentation of alternative performance measures, which are often used within the strategic report.

The FRC's Guidance is intended to represent best practice for all companies required to prepare a strategic report.

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

- a focus on purpose, i.e., why the entity exists and how it intends to fulfil its purpose, thereby generating and preserving value;
- how the entity engages with major stakeholders and takes their views into account when making significant decisions;
- an explanation of values, behaviour and culture within the entity;
- 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;
- considering risks arising from the impact the entity has on external parties when identifying and reporting on principal risks and uncertainties, in addition to the risks facing the entity;
- 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; and
- 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.

The revised Guidance encourages 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.

The FRC's consultation period closes on 24 October 2017.

Duty to promote the success of the company (s172, CA2006) – A reminder

(1) 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 —

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

(2) Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes.

(3) The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.

The FRC has taken another look at materiality

Directors are required to exercise their judgement in deciding what level of disclosure is necessary.

A number of additional considerations have been included in the proposed revisions to the section on materiality within the Guidance. The proposed revisions state that when determining whether information is material to the shareholder, 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. In addition, directors should apply judgement based on their assessment of the relative importance of the matter to the entity's development, performance, position or future prospects and the impact of its activity.

In relation to the link with audit materiality, it is made clear that whilst the disclosure of the auditing materiality figure in the audit report may focus attention on materiality as a number, 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, more qualitative, assessment may be required by directors.

Key changes

The Companies Act sets out a series of disclosure requirements for the strategic report and for 2017 these requirements have been extended to include the additional matters required by the EU Non-Financial Reporting Directive. The FRC's best practice Guidance takes these requirements as a basis but then provides suggestions for the nature of information which should be provided to best demonstrate how the directors are meeting their duties.

Below we have drawn out the key changes proposed to the FRC's Guidance on the Strategic Report indicating which element of the report they relate to.

Company purpose	Strategy	Business model – key relationships & resources	Principal risks & uncertainties	Key performance indicators	Non-financial reporting matters

1. Company purpose

Company purpose	**Strategy**	Business model – key relationships & resources	Principal risks & uncertainties	Key performance indicators	Non-financial reporting matters

The draft Guidance explains that a company's success depends on its continuing ability to generate and preserve value and that this involves a complex network of relationships with a range of stakeholders. The strategic report should provide information about the most important of those relationships and how those relationships are taken into account in the decision making process. The FRC believes this will provide insight into a company's purpose and culture and should be discussed in the strategic report.

The draft Guidance has incorporated a new perspective on purpose, framing how a company can describe itself and its strategy:

Purpose Why an entity exists	**Strategy** How an entity intends to fulfil its purpose	Why and how the entity aims to generate and preserve value in addition to creating value for shareholders

We define purpose as an articulation of the alignment between business model and external impact. This alignment enables companies to set a vision of impact that can become a platform for strategy, culture and stakeholder engagement – combining for long term sustainable success.

Areas for boards to consider

- Is the board in agreement regarding the purpose and strategy of the company? Are you satisfied with how this is described to shareholders in the strategic report?
- Is there good alignment between company purpose, values, strategy and business model?
- Is it clear how the financial and non-financial objectives of the entity are drivers for the stated values, behaviours and culture?
- Does the board believe it is time to revisit the objectives designed to support company purpose in the light of long term systemic risks?
- An obvious further question is are incentives aligned with purpose, values and strategy?

2. Other sources of value and allocation of resources

Company purpose	Strategy	**Business model – key relationships & resources**	Principal risks & uncertainties	Key performance indicators	Non-financial reporting matters

The draft Guidance reaffirms that the strategic report should include information relating to sources of value that are not recognised in the financial statements. These might for example include a highly trained workforce, intellectual property or internally generated intangible assets. The strategic report should identify these sources of value and explain how they are managed, sustained and developed.

Companies with very different divisions may wish to to explain each business model separately.

In addition, the draft Guidance calls for a discussion of how the allocation of resources will support the company in achieving its strategy. This echoes calls from the Investment Association in its recent Long Term Reporting Guidance to provide more detail on resource allocation decisions – a summary of this can be found in our half year round-up On the board agenda – H2 2017.

Areas for boards to consider

- Do you currently receive information at a board or audit committee level regarding sources of value that are not recognised in the financial statements? How regularly is this discussed?
- Do you believe all material sources of value have been identified?
- How actively are these other sources of value managed, sustained and developed and how readily could management describe this in the strategic report?
- When making decisions about the strategic direction of the company, are stakeholder views sought when commercially feasible and whose responsibility is it to bring these views to the board?

3. Section 172 reporting

Company purpose	Strategy	**Business model – key relationships & resources**	Principal risks & uncertainties	Key performance indicators	Non-financial reporting matters

The original version of the Guidance stated that the aim of the strategic report was to provide shareholders with information to enable them to assess how the directors have performed their duty to promote the success of the company. The proposed revisions to the Guidance expand the aim of the strategic report to make it clear that the information should also cover how the directors, in meeting their duty to promote the success of the company for the benefit of the members as a whole, have had regard to the matters set out in s172.

The draft Guidance suggests that the following "encouraged content elements" should be provided in the strategic report in order to meet its overall aim:

- Identification of the key stakeholders.
- How the relationships with key stakeholders are developed and maintained.
- How the key stakeholders are engaged and what regular interactions there have been during the period.
- How the interests of these stakeholders were taken into account when making strategic decisions in the period.

The FRC emphasises that the matters listed in s172 should not be applied as a checklist.

The FRC recognises that the needs of wider stakeholders may not be met wholly by reporting designed to meet the needs of shareholders and encourages companies to consider other, additional options for reporting which may be at a different materiality level and sit outside the annual report. Examples could be a separate sustainability report or presentations at stakeholder forums.

Areas for boards to consider

- Do you have robust mechanisms to seek and to capture the views of all material stakeholders and to bring these views to the attention of the board?
- Does the company have a reasonable approach for considering materiality in the context of stakeholders, third party expectations of the company and related non-financial disclosure? Has the board seen the outcome of this exercise?
- In board meetings and papers submitted to the board, where appropriate, are the matters referred to in s172 actively considered and clearly minuted?
- In the 2017 reporting season, many FTSE 350 companies started including details on key stakeholders and how the company engages with those stakeholders when describing their business model. If you are not one of these you should now consider assessing your own company's status of engagement with, and ability to report about, engagement with stakeholders.
- When reporting employee engagement mechanisms, the board should consider the three options set out in the Government's corporate governance reform proposals: a designated non-executive director; a formal employee advisory council; or having a board director from the workforce, since the UK Corporate Governance Code is likely to be updated in 2018 to require companies to adopt one of these mechanisms or give a meaningful explanation of why they have not (the "comply or explain" basis).
- Does the company's external reporting strategy consider whether additional reporting outside the annual report, or other methods of communication such as meetings, could help to better meet the needs of important stakeholder groups?

4. Principal risks and uncertainties

Company purpose	Strategy	Business model – key relationships & resources	**Principal risks & uncertainties**	Key performance indicators	Non-financial reporting matters

The section of the draft Guidance on principal risks and uncertainties has been updated to expand the nature of risks to be considered and reported on. In addition to the risks facing the entity, risks arising from the impact the entity has on external parties should also now be considered. The updated Guidance suggests that the entity should look beyond its own operations and consider risks arising from its business relationships, products and services, including risks from other parts of the supply chain in which it sits.

In addition the draft Guidance states that where the entity is facing long-term systemic risks which may have a material effect on the entity's ability to generate and preserve value in the long term, for instance risks arising from climate change or risks arising from changing technology, the strategic report should explain how the directors expect the entity's strategy and business model to change in response to those risks. For example, will there need to be changes to products, production processes or markets served?

Under the requirements of the EU Non-Financial Reporting Directive, companies are now required to provide disclosures in respect of the environment, employees, social matters, respect for human rights, and anti-corruption and anti-bribery matters (see 'Non-financial reporting matters' section below). This includes considering the impact of the company's business on these matters, where material to shareholders, and any principal risks relating to these matters. These items are now therefore required by law.

Areas for boards to consider

- What work needs to be undertaken by the company to ensure that the current list of principal risks and uncertainties includes risks arising from the impact the entity's relationships, products or services have on external parties?
- Has management been through an exercise to identify long term systemic risks to the business, either on a stand-alone basis, as part of the annual strategy review, or as part of the regular assessment of principal risks?
- Has the board considered how to respond to those long term systemic risks – and is the response properly described in the strategic report?

5. Alternative performance measures

Company purpose	Strategy	Business model – key relationships & resources	Principal risks & uncertainties	**Key performance indicators**	Non-financial reporting matters

Directors will be familiar with the ESMA Guidelines on Alternative performance measures (APMs) and the FRC has updated the Strategic Report Guidance to reflect the recommendations in those guidelines. The following disclosure principles have been included for presenting APMs:

a) APMS should be defined and the basis of calculation explained.

b) APMs should be given meaningful labels reflecting their content and basis of calculation.

c) A reconciliation of the APM to the most directly reconcilable line item, subtotal or total presented in the financial statements of the corresponding period should be disclosed.

d) APMs should not be given more prominence than the statutory figures.

e) APMs should be accompanied by comparatives for the corresponding previous periods.

f) The definition and calculation of the APM should be consistent over time.

Areas for boards to consider

- The FRC's Corporate Reporting Review Team has made it clear that they will be assessing the presentation of APMs against these guidelines, so boards should ensure these are followed.
- When reviewing the annual report boards and audit committees should consider the clarity and balance of prominence of APMs used.

6. Non-financial reporting matters

Company purpose	Strategy	Business model – key relationships & resources	Principal risks & uncertainties	Key performance indicators	**Non-financial reporting matters**

If you have more than 500 employees and are quoted or are another company within scope (see Need to Know: Non-Financial Reporting Regulations), the following disclosures are required under the Companies Act for periods commencing on or after 1 January 2017. These requirements have also been reflected in the updated FRC Guidance (without the 500 employee threshold).

To the extent necessary for an understanding of the development, performance or position and impact of its activity, the strategic report should include information in relation to, as a minimum:

a) environmental matters (including the impact of the entity's business on the environment);
b) the entity's employees;
c) social and community matters;
d) respect for human rights; and
e) anti-corruption and anti-bribery matters.

The strategic report should include a description of the policies pursued by the company in relation to non-financial matters and any due diligence processes implemented by the company in pursuance of those policies. It should also include a description of the outcome of those policies.

If the company does not pursue policies in relation to one or more of these matters, the strategic report must contain a clear and reasoned explanation for the company not doing so.

The revised guidance is clear that reporting on non-financial matters should be integrated within the rest of the strategic report and should not be presented in isolation. Directors should make clear how these matters have been considered when determining the entity's strategy and business model, principal risks and uncertainties and KPIs.

Areas for boards to consider

- Ensure you understand if your entity falls within the scope of these regulations.
- Ensure that you have policies in these areas - and control, supervision and reporting processes in respect of the implementation of your policies – in particular, reporting on outcomes may need careful consideration.
- The project management of this year's annual report just became more complex – it's time to review who in your organisation will be responsible for pulling these varied disclosures together and the assurance process you wish to see followed in respect of production of the annual report.
- Early discussion with your auditors will be beneficial to ensure that what your company produces will be sufficient for the auditors' front half responsibilities.

Linkages

As with the original Guidance, there is encouragement for entities to prepare more cohesive annual reports. The 'linkage examples' included in the draft Guidance illustrate ways in which interdependencies or relationships between strategic report content elements and disclosures placed elsewhere in the annual report might be highlighted or presented. Examples in the draft Guidance include opportunities to link the discussion of:

- Development and performance during the year and the strategy in place at that time.
- Strategy and position in the value chain.
- Key performance indicators and principal risks.
- Key performance indicators and drivers of directors' remuneration.
- Principal risks and the longer term viability statement.
- Tax strategy and community and social matters.

Effective use of cross-referencing and signposting can help establish these linkages.

Deloitte View

- Annual reports will contain more focused information and be richer documents for shareholders and wider stakeholders.
- These changes reflect the changing societal expectations of the role of business in our communities.
- Although these are presented as changes to reporting, for some companies, it is likely that changes in processes, behaviours and perhaps even in the nature of boardroom discussions may be necessary, and therefore careful consideration and planning will be required – and urgently for those who plan to adopt all aspects in December 2017 reporting.
- Companies should ensure they have assessed potential sources of risk thoroughly and consulted externally where they do not consider they have sufficient internal expertise.
- Companies that have not yet fully considered their stakeholder map, the importance of their different stakeholder relationships and how to keep key stakeholders informed and obtain their views need to act now. Choices need to be made thoughtfully in this area.
- Where companies are required to or decide to prepare separate reports or information for stakeholders outside of the annual report, it is important to consider the appropriate governance arrangements for this information and whether additional internal or external assurance is required.
- Audit committees should consider what enquiries to undertake and what reporting to receive in relation to this new non-financial reporting, together with any s172 disclosures, as part of their responsibilities to monitor the integrity of corporate reporting and also, where requested by the board, to ensure that the annual report is fair, balanced and understandable.
- Early discussion with the Company's auditors will be worthwhile.

For further information:

The FRC's draft Guidance on the Strategic Report and invitation to comment are available at: https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2017/August/FRC-consults-on-non-financial-reporting-guidance.aspx

The Government's Corporate Governance Reform: The Government response to the green paper consultation is at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/640470/corporate-governance-reform-government-response.pdf

The Investment Association's Long Term Reporting Guidance can be accessed at https://www.theinvestmentassociation.org/assets/files/press/2017/Long%20Term%20Reporting%20Guidance%20(v1).pdf

Deloitte's 2030 Purpose publication can be accessed at www.deloitte.com/2030purpose

Deloitte's Need to Know on the Non-Financial Reporting Regulations is at https://www.iasplus.com/en-gb/publications/uk/need-to-know/2017/ntk-non-financial-reporting-regulations

Deloitte's Need to Know: FRC publishes consultation on amendments to its Guidance on the Strategic Report can be accessed at: https://www.iasplus.com/en-gb/publications/uk/need-to-know/2017/need-to-know-frc-publishes-consultation-on-amendments-to-its-guidance-on-the-strategic-report

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