

23 October 2017

Deepa Raval
Financial Reporting Council
8th Floor
125 London Wall
London EC2Y 5AS

By email to: narrative@frc.org.uk

Dear Ms Raval

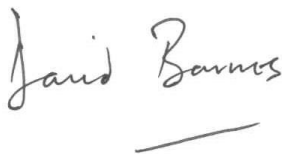
Exposure Draft: Draft amendments to Guidance on the Strategic Report – Non-financial reporting

Deloitte LLP welcomes the opportunity to comment on the Financial Reporting Council's *Draft amendments to Guidance on the Strategic Report – Non-financial reporting – Exposure Draft (the Exposure draft)*.

We support the draft amendments that have been made to the Guidance on the Strategic Report (the updated Guidance) as set out in the Exposure draft. We have set out our responses to the consultation questions in Appendix 1 and suggest a few clarifications that would improve the usability of the updated Guidance in Appendix 2.

We would be happy to discuss our letter and the draft proposals with you. If you have any questions, please contact Tarryn Hyland on 020 7303 4678 or tahyland@deloitte.co.uk or Amanda Swaffield on 020 7303 5330 or aswaffield@deloitte.co.uk.

Yours sincerely



David Barnes

Global Managing Director of Public Policy
Deloitte LLP

Appendix 1

Responses to detailed questions

Question 1 Do you agree with the approach for updating the Guidance for the changes arising from the implementation of the non-financial reporting Directive?

We are supportive of the approach for updating the Guidance for the changes arising from the implementation of the non-financial reporting (NFR) Directive. A simple and clear approach applicable as best practice for all companies, whilst making clear which aspects are mandatory for specific categories of companies and qualifying partnerships, is helpful. This avoids complicated multiple versions of the Guidance.

The way that the NFR Directive has been implemented into UK Law has however resulted in complexity, with different categories of companies being subject to differing requirements for the strategic report. Given that the legal requirements are difficult to follow, we suggest the Financial Reporting Council (FRC) support preparers in determining which legal requirements they are subject to. We appreciate that the Guidance is deemed best practice and should be encouraged, but it is important that the mandatory requirements for entities of all sizes are clear. At present various footnotes are provided throughout the updated Guidance, including within the tables in appendices III and IV, which is a little cumbersome for users. Also, the boxed text in bold type refers to the legal requirements, but not all have a footnote explaining where that requirement derives from. A completeness check should be carried out to ensure that readers are clear about the source of the requirement.

A clearer explanation of scoping upfront, and setting out the various 'tiers' of reporters e.g. listed equity (>500 employees), listed debt (<500 employees), unlisted credit institution (>500 employees), unlisted entity (>500 employees) etc., would help preparers navigate the Guidance. Also, including a cross reference between the legal requirements as set out in appendices III and IV to the relevant paragraph in the Guidance may help preparers work out what is mandatory for the relevant type of entity. We have included a table in Appendix 3, from our newsletter¹ on this topic, which might be helpful as a first step for preparers.

We believe clarification would be helpful regarding the interaction between the strategic reporting requirements² and the regulations requiring the preparation of a "non-financial information statement"³. We understand that entities may achieve compliance with the law by integrating the required non-financial information within the strategic report, as explained in summary paragraph (x) and paragraph 7.30. However, it is confusing when the law also allows entities to present a separate non-financial information statement, because the impact of this on the non-financial matters to be presented in the strategic report is unclear. It would be useful to clarify that even if companies do choose to present a separate non-financial information statement external to the annual report, companies must, where they are in scope, still comply with the strategic report requirements to deal with similar matters in the strategic report.

Question 2 Do you support the enhancements that have been made to Sections 4 and 7 of the Guidance to strengthen this link?

We support the enhancements that have been proposed to Sections 4 and 7 of the Guidance to strengthen the link between the strategic report and section 172 of the Companies Act 2006 (the Act). The emphasis in the updated Guidance on reporting how directors consider broader stakeholders, whilst promoting the success of the company, is in line with the direction of travel of the Government's Corporate Governance Reform proposals. It also reflects the principles of the IIRC's⁴ International <IR> Framework, the FRC's

¹ Need to Know — Non-Financial Reporting Regulations (February 2017) available at: <https://www.iasplus.com/en-gb/publications/uk/need-to-know/2017/ntk-non-financial-reporting-regulations>

² Section 414C of the Companies Act 2006

³ Section 414CB of the Companies Act 2006

⁴ The International Integrated Reporting Council's <IR> Framework is available at: <http://integratedreporting.org/wp-content/uploads/2013/12/13-12-08-THE-INTERNATIONAL-IR-FRAMEWORK-2-1.pdf>

report on Corporate Culture and the Role of Boards and the recent report on stakeholder engagement issued by ICSA and the Investment Association⁵.

We appreciate that any 'encouraged' disclosure elements are clearly signposted as being disclosure beyond the current legal requirements (although we note that some of these may become mandatory in due course as a result of Corporate Governance Reform). It is helpful for entities to understand what is desirable, as opposed to mandatory.

Our research shows that while only a small number of companies are explicitly referring to the requirements of s172 of the Act in their strategic report or corporate governance statement — in particular the need to have regard to certain matters e.g., wider stakeholders, whilst promoting the success of the company — we note that a growing number of companies describe, to varying degrees, how they engage with wider stakeholders. This view arises from the findings of our recent survey on corporate reporting, *Annual reporting insights 2017*, available at www.deloitte.co.uk/annualreportinsights.

We have some drafting suggestions on Sections 4 and 7, which are included in Appendix 2.

Question 3 Do you have any suggestions for further improvements in this area?

Given the expected introduction of secondary legislation to be issued by the Department for Business, Energy & Industrial Strategy (BEIS) and likely amendments to the UK Corporate Governance Code as part of Corporate Governance Reform, consideration should be given to the timing of the issuance of the finalised updated Guidance. Our recommendation is to publish an interim revised version of the Guidance (i.e. a "staff draft") as soon as possible following this consultation, to help guide preparers on the NFR Directive requirements and to encourage reporting on s172 matters, but make clear that a final version (i.e. with full FRC approval due process) will be published once the final legislative and Code changes have been issued.

We believe that investors are increasingly taking non-financial reporting into account in their decision making process. The principles outlined in paragraphs 7.30 – 7.43 helpfully provide guidance on how directors should report on the impact of the entity's activity, including potential long term outcomes and the impact on society more widely. To strengthen the link between the principles described in paragraph 7.36 and paragraph 7.39, we suggest the updated Guidance be amended to include a statement that there should be linkage between non-financial KPIs (such as number of stakeholder meetings, customer satisfaction survey results or staff turnover) and the narrative discussion of relevant non-financial reporting matters. We have included amended working to paragraph 7.36 in Appendix 2 to emphasise this link.

Question 4 Do you agree with the draft amendments to Section 5?

We agree that the updated Guidance on materiality should maintain the overriding principle that information should be presented in the strategic report based on the information needs of shareholders, although we have some concerns around the wider description of materiality provided in Section 5.

The statement in paragraph 5.6 rightly highlights that in the context of qualitative information, numerical materiality is of less importance. However, we are concerned that the reference to audit materiality adds confusion. Audit and preparer materiality are different concepts and are used for different purposes. We suggest that paragraph 5.6 be removed.

As identified in paragraph 5.3, the information needs of the entity's shareholder base may be diverse, and judgement by directors will be required in determining materiality for the purpose of the strategic report. It would be helpful if the approach to determining and applying materiality from the perspective of the company, or more specifically its members, was disclosed in the strategic report. At present, few companies explicitly assert that they are considering materiality when it comes to their narrative reporting⁶. Those companies that did explicitly mention how materiality was applied in their narrative reporting, did so in

⁵ The stakeholder voice in board decision making – new guidance from ICSA and the Investment Association available at: <https://www.icsa.org.uk/knowledge/resources/stakeholdervoice>

⁶ See *Annual reporting insights 2017*, page 11

relation to corporate social responsibility (CSR) information only, most likely because of the requirement in the Global Reporting Initiative's guidance on materiality in sustainability reporting. This is an area for potential linkage, as suggested in our response to Question 5 below.

Question 5 Do you have any suggestions on how the Guidance could encourage better linking of information in practice, or common types of disclosures that would benefit from being linked?

We support the use of linkage examples provided in the updated Guidance. Best practice examples or case studies are helpful for companies. However, it is probably not practical to include specific examples in the updated Guidance as they would date the publication. Examples provided as part of the output of Financial Reporting Lab projects, and through publication of surveys and insight publications by the firms, meet this need.

We are not clear why the disclosure requirements in the updated Guidance relating to trends and factors have been moved from within the business environment category, which is primarily a forward-looking narrative, to the business performance category, which is primarily a historical account of past activity. We believe that the linkage between the trends and factors of the markets in which the company operates and the principal risks and uncertainties facing the company should be clearly established. We are concerned that, by moving the trends and factors content element to the business performance analysis, sufficient context in which to understand the risks and opportunities will not be provided.

Our research shows that linkage across the annual report remains an area for improvement. We note that many companies seek to address this through the use of icons which represent elements of the strategic report, and then provide cross references using those icons to connect elements of the strategic report. In some cases we believe that usage of icons and basic cross references is excessive and does not actually add value where there is no explanation of why the connection has been made (where not self-explanatory).

Particular areas where effective linkage could be developed further are between:

- strategy, risks and viability;
- risks, KPIs and dividend policies⁷;
- non-financial KPIs and non-financial reporting matters, as noted above;
- KPIs (both financial and non-financial) and directors' remuneration; and
- CSR disclosures and strategy, business model and KPIs⁸.

For example, how does the consideration of wider stakeholders, presented within the CSR information, affect the business model and strategy of the company? In our *Annual reporting insights 2017* survey, we found most companies still include a separate CSR section in their reports.

Question 6 Do you agree with how the sources of value have been articulated in the draft amendments to the sections on strategy and business model in Section 7?

Yes, we agree with the articulation of the sources of value in the updated Guidance. We believe that the amendments to Section 7 include useful qualitative descriptions to help preparers identify the potential resources to be described within the strategy and business model elements of the strategic report.

Our research shows that increasingly companies are identifying the key inputs in their business model, such as customers, employees, brand and intellectual property, which are off-balance sheet sources of value.⁹ However, as recommended by the proposed Guidance, we agree that companies should be providing more information, linked to their business model disclosures, on how these resources and relationships are being managed, sustained and developed to drive long-term success.

⁷ See *Annual reporting insights 2017*, page 18

⁸ See *Annual reporting insights 2017*, page 21

⁹ See *Annual reporting insights 2017*, page 18

The suggestions, in paragraph 7.19, on quantifying the development and maintenance of key resources and relationships in the strategic report are also helpful and we are aware that this is an area in which investors expect to see more reporting.

Question 7 Do you consider that disclosures on how value is generated would be helpful?

We agree with the principles outlined in paragraphs 7.19 and 7.20, but observe that paragraph 7.21 could be confusing for those not deeply involved in the debates around sustainable value creation and measurement. It would be helpful to provide more background on the objective of this updated Guidance, specifically that the FRC has observed practice in this area and seeks to encourage further innovation in how companies measure their multifaceted impact.

Question 8 Do you consider that the draft amendments relating to reporting of non-financial information given sufficient yet proportionate prominence to the broader matters that may impact performance over the longer term?

Yes, we believe that sufficient yet proportionate prominence is given to broader matters that may impact performance over the longer term.

We support the emphasis on disclosing the purpose of an entity in the updated Guidance, but we have proposed some clarifications to the drafting of Section 7 which we have included in Appendix 2. Our research demonstrates that a growing number of companies are presenting a prominent description of their purpose, with increasing recognition that commercial success is linked to a commitment to value creation for a broad range of stakeholders¹⁰. Good examples of purpose statements linked what the company does to wider stakeholders.

With regards to auditors' responsibilities outlined in Section 3, we are concerned that there may be an increasing lack of understanding of what auditors are required to do in respect of the broader set of information included in the strategic report, with the belief that all information in the annual report is subject to the same level of assurance. The updated Guidance presents an opportunity for addressing this issue through preparer and investor education. In addition, the Audit and Assurance Lab may wish to do some work in this space, perhaps during Phase 2 of its initial project, looking at the extent to which companies are obtaining internal or external assurance on some or all of the narrative in their annual reports.

Question 9 Are there any other specific areas of the Guidance that would benefit from improvement?

Interpretation of 'the impact of its activity'

The phrase 'and the impact of its activity' has been included throughout the updated Guidance as a result of it being in the NFR Directive. A description of 'impact' is provided in paragraphs 4.3 and 4.4, clarifying that this is the impact of the organisation on wider stakeholders to the extent that this is of material relevance to shareholders. It would be helpful if this description was provided earlier in the document, for example after paragraph 2.2. We suggest including a new paragraph 2.3 to address this.

Amendments to Section 7

The staff draft of the updated Guidance, showing the track changes version of the updated Guidance, indicates a significant level of change to Section 7. However, we note that a number of the underlined paragraphs have simply been moved around rather than changed. This, in our view, unnecessarily overstates the extent of change. For example, 'new' paragraphs 7.58, half of 7.62, and 7.63 – 7.65 are carried over

¹⁰ See *Annual reporting insights 2017*, page 6

from the current Guidance, only the paragraph numbers have changed. Paragraphs 7.8, 7.11, 7.32 (and others) have moved and changed very slightly yet are marked, in their entirety, as new. Not all original paragraphs are marked as deletions, e.g. 7.30. It would be better to distinguish between text that has not changed (just the geography) and text that is new.

Statement of reasons for change

We encourage the FRC to publish a summary in the final Guidance, based on the Advice to the Corporate Reporting Council which is included as Appendix II to the Exposure draft, explaining the rationale for the changes made to the Guidance. We suggest that this is included in a prominent place, rather than simply appending the Advice to the Corporate Reporting Council to the document.

Impact of systemic risks

As currently drafted, paragraph 7.25 reads as though companies should explain what their revised strategy and business model will be in response to long-term systemic risks. We do not believe that this is the intention of the paragraph and suggest the paragraph be amended to make clear it is the potential impact the risk may have on the current strategy and business model, and the steps the company is taking to mitigate this risk. We have suggested some revised wording in Appendix 2. If left as drafted we suspect it will merely result in boilerplate disclosures.

Appendix 2

Other issues

These issues are listed in paragraph order rather than order of importance.

Para	Issue
2.2	The list of information to disclose in the strategic report, includes the impact of the company's activities, however this item is introduced with the conjunction 'or'. This should be 'and'.
3.5	It may be useful to include a cross reference to materiality, in paragraph 2.2 or 5.3, to emphasise the application of materiality in determining the scope and content of the annual report and accounts.
Heading Section 4	We suggested amending the title of Section 4 to read "The purpose of the strategic report", to avoid confusion with references to the purpose of a company.
4.1 & 4.4	Insert full stops at the end of each paragraph.
4.2	To help preparers we suggest including ".....and should also explain how <u>the entity has engaged with stakeholders to understand the material issues that those relationships</u> are taken into account in the boards' decision making"
4.3	There may be some inconsistency between paragraph 4.3, which includes the requirement in S414C of the Act ¹¹ to describe the entity's 'strategy', and other paragraphs which do not include the word 'strategy', such as paragraph 2.2, which is aligned to the requirements of the NFR Directive, and paragraph 5.5, which provides a list of matters to consider in determining materiality. Consistency between these paragraphs, around the purpose of the strategic report, would be improved if 'strategy' were also included in the lists outlined in paragraphs 2.2 and 5.5.
4.4	It is unclear from the wording in paragraph 4.4 if the suggestion is to disclose in the strategic report how the impact on stakeholders has been considered, or if the impact on stakeholders should be considered by the board but not reported on.
5.6	Delete, as suggested in our answer to Question 4.
7.5	We suggest amending as follows: "An entity's purpose, its strategy, and its business model are interrelated <u>but distinct</u> concepts. Different businesses may use different terms for these concepts and/or may approach them in a different order. The disclosure of an entity's purpose, strategy and business model should together explain <u>the relationship between an entity's ambition for external impact (purpose), the choices for achieving that impact sustainably through commercial success (strategy) and the means of activating those choices (business model).</u> what an entity does and how and why it does it. "
7.6	We suggest amending as follows: "An entity's purpose is why it exists <u>in terms of its contribution to wider society through its core business.</u> The entity's strategy describes the intended means of fulfilling its purpose. Together they provide an overview of why and how the entity aims to generate and preserve value."
7.9	We suggest amending as follows to make clear it is appropriateness of the strategy that is being referred to: "A description of the strategy for achieving an entity's objectives provides insight into its future development, performance, position and future prospects. The disclosure of the entity's objectives places the strategy in context and allows shareholders to make an assessment of <u>the</u> its appropriateness <u>of the</u> strategy. "

¹¹ Section 414C(8)(a) of the Compact Act 2006

7.9	<p>We suggest amending the Linkage example:</p> <p>"Relating the development and, performance of the entity during the year to <u>the</u> strategy that was in place at the time, will allow shareholders to assess the directors' actions in pursuit of the entity's <u>purpose-led</u> objectives, how directors have discharged their duty under section 172 and may be relevant in an assessment of the entity's future prospects.</p>
7.10	<p>To clarify the focus on the content element example under paragraph 7.20, which might also be an appropriate example of stakeholder engagement supporting paragraph 7.18, it would be helpful to insert additional description, such as "To illustrate an element of its culture, values and behaviours, an entity could set out..."</p>
7.11	<p>In the last sentence of paragraph 7.11, 'many' should be 'may'.</p>
7.12	<p>Remove the word 'more' in the first sentence to encourage concise descriptions of the business model.</p>
7.22	<p>It would be useful to include the sub-heading "Principal risks and uncertainties" before paragraph 7.22.</p>
7.25	<p>We suggest amending the paragraph, as explained in our response to Question 9, as follows:</p> <p>"...the strategic report should explain how the entity's strategy and business model might be impacted and the steps the board is taking to mitigate the risk."</p>
7.36	<p>Amendment to encourage reporting of non-financial measures used by boards when monitoring the impact of entities' activities:</p> <p>"The strategic report should include a description of the policies pursued by the company in respect of 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 <u>and how the board monitors these matters, including the non-financial measures used.</u>"</p>
7.57	<p>In relation to the guidance on the use of Alternative Performance Measures (APMs) as Key Performance Indicators (KPIs), we would encourage the requirement in relation to prominence, described in paragraph 7.57(c) to be presented as a separate bullet point.</p>
Glossary	<p>It would be helpful if the definition of purpose in the Glossary were expanded to distinguish between purpose of the entity and purpose of the strategic report as both are used throughout the Guidance and may cause confusion. For example:</p> <p><u>"Purpose (of an entity) – why an entity exists in terms of its contribution to wider society through its core business activities."</u></p>
Appendices III and IV	<p>We suggest that cross references between the legal requirements, as set out in appendices III and IV, to the relevant paragraph in the Guidance may help preparers work out what is mandatory for them.</p>

Appendix 3

Overview of non-financial information requirements and the companies they affect

Existing non-financial information (Existing) requirements and EU NFR Directive (NFRD) non-financial information requirements for UK companies.

Company type	Principal risks		Environmental, social and employee matters		Human rights matters		Anti-corruption and bribery matters		Diversity matters	
	Existing	NFRD	Existing	NFRD	Existing	NFRD	Existing	NFRD	Existing	NFRD
Listed equity (> 500 employees)	√**	✓	✓	✓	✓	✓	X	✓	√*	√***
Listed equity (≤ 500 employees)	√**	X	✓	X	✓	X	X	X	√*	√***
Listed debt (> 500 employees)	√**	✓	X	✓	X	✓	X	✓	X	X***
Listed debt (≤ 500 employees)	√**	X	X	X	X	X	X	X	X	X***
Unlisted credit institutions (> 500 employees)	√**	✓	X	✓	X	✓	X	✓	X	X
Unlisted credit institutions (≤ 500 employees)	√**	X	X	X	X	X	X	X	X	X
Unlisted insurance undertakings (> 500 employees)	√**	✓	X	✓	X	✓	X	✓	X	X
Unlisted insurance undertakings (≤ 500 employees)	√**	X	X	X	X	X	X	X	X	X

* Whilst some disclosures regarding diversity are already required in the existing UK framework, these differ from those in the EU NFR Directive.

** Whilst the disclosure of principal risks is a requirement of all UK companies within the scope of the strategic report requirements, the EU NFR Directive explicitly refers to principal risks relating to the non-financial information matters (i.e. environmental, social, employee, human rights, anti-corruption and bribery matters).

*** The diversity disclosures do not apply to issuers which do not have shares admitted to trading on an EU regulated market, unless the issuer has issued shares which are traded on an EU multilateral facility. Companies that meet the size criteria to qualify as small or medium-sized under company law are exempt from the diversity disclosures.