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Re: FRC Guidance on Narrative Reporting

Dear Melanie

I would like to thank the FRC for its work on updating its Guidance on Narrative Reporting. The guidance accompanies the narrative reporting related changes to the Companies Act 2006 (the "Act") that came into force on 1 October 2013, through the Companies Act 2006 (Strategic Report and Directors Report) Regulations 2013.

I understand that the consultation process for the Guidance on the Strategic Report has uncovered some areas of uncertainty. I hope that the below helps shed light on the Department's view on these issues.

Policy objective

The policy objective behind these legislative changes was to simplify and restructure annual narrative reports, by creating a separate strategic report to replace the business review. We believe that this will result in more relevant information being provided to members. The changes also removed some reporting obligations for all companies and require quoted companies to make some additional disclosures. In addition, they permit companies to send a strategic report instead of a summary financial statement to those members who do not wish to receive the full annual accounts and report (the 'annual report'). The directors' report was intended to be the location for supporting information.

Directors Duties and Narrative Reporting

Questions have been asked about the relationship between narrative reporting and the duty of directors as set out in section 172 of the Act¹. This duty is to promote the success of the company for the benefit of its members as a whole, having regard to certain matters, which are set out in a (non-exhaustive) list in section 172.²

The purpose of the strategic report is to inform members of the company and help them assess how the directors have performed their duty under section 172 (section 414C (1) of the Act).

Whilst directors should have regard to the matters set out in section 172 when they are running the company, these matters would only be reported in the strategic report when they are necessary for an understanding of the position, performance and development of the company's business.

Materiality

The strategic report must contain a fair review of the company's business and a description of the principal risks and uncertainties facing the company. In assessing what information should be included in the strategic report under section 414C of the Act, directors must decide if this information is "*necessary for an understanding of the position, performance and development of the company's business*". If the information is necessary for the company's members to understand this, then it must be included.

If directors decide that the information required by 414C(7)(b) is not necessary, they cannot simply omit it. Under section 414C(7), where some or all of the information set out in section 414C(7)(b) is not deemed by the directors to be material and has not been included, the strategic report must identify which of this information has been omitted.

The Department believes that the concept of materiality as set out in the FRC guidance is consistent with the approach in the Act.

Safe Harbour

Whilst developing these legislative reforms, a consistent message stressed by many stakeholders was the need for annual reports to contain statements on factors that could affect the business in the future. Stakeholders have consistently argued that, as it is impossible to predict the future, directors need certainty on the scope of their liability when making such statements. This is why section 463 of the Act contains a provision clarifying this liability (known as the "safe harbour" clause). Provided a director does not make a deliberately untrue or misleading statement; is reckless as to whether such a statement is misleading or untrue; or dishonestly conceals a material fact by way of an omission, then they will not be liable to compensate the company for any loss incurred by it in reliance on the report. This is true for those reports to which the safe harbour

¹ The Companies Act 2006 c 46

² Where a company's purpose includes, or wholly consists of purposes other than benefiting its members, the obligation will include, or consist of, promoting the achievement of such purposes (section 172(2) of the Act).

clause now applies: the strategic report, the directors' report and the directors' remuneration report.

BIS is concerned that the overly cautious might place inappropriately large volumes of information, including that not required to meet a specific legal requirement, in these reports in order to benefit from the "safe harbour" clause. That is not the intention behind the legislation. Should this manifest itself in such a way that it detracts from clear and concise reporting then the Department may need to revisit the operation of the safe harbour provision in future.

Incorporation by Cross-reference

Respondents to your consultation asked whether the safe harbour clause would apply to information incorporated into the protected areas by cross-reference.

It is BIS' view that information incorporated by cross-reference into one of the protected areas³ from other parts of the annual report and necessary to meet the requirements in one of the protected areas will be covered by the safe harbour provision.

Conversely, it is our view that information placed outside of the annual report, will not be covered by the safe harbour provision even if the annual report contains reference to it. We believe that this strikes the appropriate balance between ensuring that the statutory reports can be written concisely and in a way appropriate to each company, whilst also ensuring that members have all relevant information available to them in one place.

Directors' should remember that in order to benefit from the safe harbour protection, they should be satisfied that any information contained in protected areas is not misleading or untrue.

Section 426 option 'Strategic Report with Supplementary Material'

Some respondents to your consultation asked about the possibility of sending a "Summary Strategic Report" when selecting the section 426 option of providing a strategic report with supplementary material. This was due to concern that the strategic report would be overly long.

The legislation makes clear that if companies wish to send the replacement for a Summary Financial Statement instead of the full annual accounts and report then they can only do so by sending the strategic report plus the supplementary material listed in statute (see sections 426 and 426A of the Act). This means that companies would not be able to replace the strategic report with a summary strategic report.

However there is nothing to prevent companies from preparing a voluntary non-statutory document for their members. Such a report will not have any statutory underpinning, and hence the "safe harbour" provisions will not cover any information in this report.

Should companies choose the section 426 option of providing a strategic report with supplementary material then the safe harbour provision will of course continue to apply to the strategic report itself.

³ the strategic report, the directors' report or the directors' remuneration report .

Section 426 option 'Strategic Report with Supplementary Material' – Incorporation by Cross-Reference

Where a company selects the option in section 426 of providing a strategic report with supplementary material, information incorporated by reference (whether from a protected area or not) into the strategic report in the annual report is considered part of the strategic report issued to meet the requirements of section 426.

Electronic Reporting

You asked for clarification on electronic reporting. If the company's articles allow and members agree, then there is nothing to prevent companies from sending information electronically to their members. Companies will, for example still be required to provide a paper copy of their annual report to those members who have requested one. For further details see Sections 1143 to 1148 and Schedules 5 and 6 of the Act.

It is important to reiterate that the annual reports are not documents prepared for the government or regulators. It is for the directors of a company to show, to its members, how they have fulfilled their duties to the company and to judge the utility of the information that supports this.

We hope that this explanation goes some way to addressing the issues that your consultation has raised.

Yours sincerely

A handwritten signature in black ink, appearing to be 'CH', with a long, sweeping horizontal line extending to the right.

Christopher Hobley
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Department for Business, Innovation and Skills