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14 November 2013

AFM response on Exposure Draft: Guidance on the Strategic Report

1. I am writing in response to this discussion paper, on behalf of the Association of Financial Mutuals. The objectives we seek from our response are to:

    - Comment on the proposals in the consultation; and
    - Confirm how AFM has communicated changes to its members who adopt our annotated version of the UK Corporate Governance Code.

2. The Association of Financial Mutuals (AFM) represents 53 member companies, most of which are owned by their customers. Between them, AFM members manage the savings, protection and healthcare needs of over 20 million people, and have total funds under management of £120 billion. The nature of their ownership and the consequently lower prices, higher returns or better service that typically result, make mutuals accessible and attractive to consumers, and have been recognised by Parliament as worthy of continued support and promotion.

3. The AFM maintains a version of the UK Corporate Governance Code annotated for mutual insurers. We recognise that the listed companies for how the Code is primarily aimed are many times bigger than most of our members, and also that the focus on shareholder-owned businesses does not entirely adapt to other business models. However, we seek to embrace the standards produced by FRC as being a clear articulation of good practice. As a testament to our success in applying standards designed for large, listed companies, rates of compliance with AFM members are very high, and the dedication required to delivering high standards of governance in very small organisations should not be underestimated.

4. In like kind, we have approached this consultation from the expectation that we are aiming to apply the guidance in equal measure to our members. We attach an annex to the paper, forming the communication we have issued to our members to encourage early adoption. However, from a practical perspective we have not insisted our members adopt the strategic report from 1 October

where they are not governed by companies act legislation, given that the consultation period for your guidance runs considerably beyond this date.

5. There are a number of reasons therefore why we have proposed that our members implement the requirements ‘as soon as practical, though not necessarily for 2013 annual reports’:

   a. Most of our members operate a 31 December year-end, and for many the considerable investment in adopting the strategic report may mean it is not practical to implement in their 2013 report and accounts, especially where many organisations have already developed their template for this year’s report;
   b. Other of our members have highlighted the significant additional cost in issuing the strategic report and associated documents, compared to the current summary financial statement;
   c. For friendly societies, some of the current reporting requirements do not apply, such as the requirement to issue all owners with a copy of the report and accounts or summary financial statement; and
   d. Some friendly societies have highlighted the need to amend their rules and constitution to produce a change in member communication.

6. We would be interested to understand from FRC to what extent it intends to monitor compliance with the new strategic reporting, and whether it plans to publish a summary of good practice it is observing. We consider this would be very helpful to our members, and we are happy to contribute to any such review from within the subscribers to our Annotated Code.

7. We attach our response to the specific questions raised in the consultation. We would be pleased to discuss further any of the issues raised by our response.

Yours sincerely,

Chief Executive
Association of Financial Mutuals

Our responses to specific Questions

Question 1: Do you think that Illustration 1 is helpful in achieving this objective?

The illustration provides a useful overview of the components of the annual report in future, albeit for organisations such as friendly societies the underlying legislation does not always apply.

Question 2: Do you agree with the objectives of each component and section of the annual report which are included in Illustration 1?

We agree.

Question 3: Do you think the guidance on the placement of information in the annual report in paragraphs 3.10 to 3.14 will have a positive influence in making the annual report more understandable and relevant to shareholders?

Yes, and this is likely to be true for other ownership models.

Question 4: Do you agree with this approach? Is the level of guidance provided on the subject of materiality appropriate?

We agree with the approach. We would expect the Board of an entity to determine for itself what information is material. We anticipate that firms will not necessarily get this balance right first time, and would welcome further elaboration of good practice over time.

Question 5: Do you agree with the proposed 'communication principles', set out in paragraphs 6.5 to 6.27 of the draft guidance, which describe the desired qualitative characteristics of information presented in the strategic report? Do you think that any other principles should be included?

We agree with the proposed communication principles, and these appear to include the key issues.

Question 6: In this draft guidance, we have aimed to strike a balance between the need to ensure that the structure and presentation of the strategic report is sufficiently tailored to the entity's current circumstances and the need to facilitate comparison of the strategic report from year to year. Do you think the guidance in paragraphs 6.26 and 6.27 achieves the correct balance?

We suggest that it is important that there is integrity between years, such that the organisation adopts a consistent approach to a particular issue, and does not risk misleading readers by interpreting issues differently from one year to the next without highlighting this.

Question 7: The 'content elements' in bold type described in paragraphs 6.28 to 6.73 do not go beyond the requirements set out in the Act, although the precise wording may have been expanded to make them more understandable. Do you think this is appropriate? If not, what other 'content elements' should be included in this draft guidance?

We consider the content elements to be appropriate and consistent with legislation, and are for the most part similar to the items reported on previously.

Question 8: Appendix I 'Glossary' uses the same definition of a business model as the Code ('how the entity generates or preserves value'). Is the level of guidance provided on the business model description in paragraphs 6.38 to 6.41 sufficient?

Question 9: Do you think that this draft guidance differentiates sufficiently between the concepts of business model, objectives and strategies? If not, why not and how might the guidance be improved?

We are not aware that these are issues that require a significant level of definition or elaboration. We consider Boards should determine these issues for themselves, so the volume of guidance here is appropriate.

Question 10: This draft guidance includes illustrative guidance (the 'linkage examples') on how the content elements might be approached in order to highlight relationships and interdependencies in the information presented. Are these linkage examples useful? If not, what alternative examples or approach should be used?

We consider that the linkage examples are helpful in reminding entities that the purpose of the strategic report is to bring life to the activities of the entity, for its owners and other users of the report and accounts.

The vast majority of owners in mutuals are laypeople, and the financial information alone does not aid their engagement. Equally, an abstract narrative will not help members of mutuals gather an understanding of the value of their ownership rights, the business of the entity or the risks to which it is exposed. Hence it is vital to build linkage between elements in the strategic report, to properly inform and better engage the reader: in this way we hope that mutuals can use the strategic report as part of a broader strategy for member engagement and to elicit a higher turnout at the AGM.

Annex: Adopting the new Strategic Report

This note has been approved by the AFM Board. It has been produced by the AFM Regulation and Governance Committee to explain how members should adopt the new style of strategic report at the earliest possible opportunity, as part of our continued intent to adopt high standards of corporate governance in the mutual insurance sector.

Background

The Government, as part of its collation agreement in May 2010, announced its intention to *'reinstate an Operating and Financial Review to ensure that directors' social and environmental duties have to be covered in company reporting, and investigate further ways of improving corporate accountability and transparency'*.

Company law has been updated, to take effect from 1 October 2013, to require certain companies to produce a strategic report as part of their annual report and accounts, for years ending 30 September 2013 onwards. FRC has duly prepared draft guidance on the content of the report, which is aligned to the UK Corporate Governance Code (see the Annex for an overview of relevant passages from the Code), and which is designed to encourage the production of shorter and more informative reports. This was issued as an exposure draft on 15 August for comment by 15 November[1].

Content of the strategic report

The strategic report has three main content-related objectives:

- to provide context for the related financial statements;
- to provide shareholders with an analysis of the entity's past performance; and
- to provide insight into the entity's main objectives and strategies, and the principal risks it faces and how they might affect future prospects.

The FRC guidance provides extensive proposals on what the strategic report should include, of which the following bullets are a brief summary:

- It should be concise, forward-looking, signpost the location of supporting detail, and reflect the collective views of the company's directors. Consistent with the changes to the Code in 2012, it should be fair, balanced and understandable.
- It should include a description of the company's principal objectives and its strategy for achieving them, along with an overview of the business model.
- The key performance indicators used to assess progress should be included, along with a description of trends or factors likely to impact future performance, and the risks and uncertainties the company faces and how it plans to mitigate them.
- The strategic report should provide an analysis of the development and performance of the business in the financial year and of its position at the end of that year. This will supplement the financial information, and cover questions commonly put to the AGM.
- Key strengths and resources of the organisation should be described (whether tangible or intangible). Social, community or environmental issues relevant to an understanding of the business should be included.

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[1] http://frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Exposure-Draft-Guidance-on-the-Strategic-Report.aspx

- An overview of the company's employees should include a breakdown of directors/ senior managers and employees by gender.

The guidance is intended to be principle-based and best practice, rather than a mandatory set of content.

According to the legislation, 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 s172'* of the Act[2].

The legislation removes the option for a firm to issue a summary financial statement, introducing the option to provide the strategic report (with some supplementary material) in its place.

Extending the strategic report to the mutual insurance sector

The specific requirements for the strategic report are incorporated into changes to company law- these will affect some AFM members, but not friendly societies[3]. However FRC has approached the guidance on the basis that it 'may be useful for other entities'.

The report builds on the current 'business review', but seeks to inform owners more effectively, with a clearer overview of how the company is being run in their best interests. Whilst the proposed content is intended for shareholders of listed companies, it seems almost entirely relevant to members of mutuals. Indeed it supports many of the elements for reporting covered in the Annotated Corporate Governance Code.

The presentation of information in a concise, narrative way is likely to be more relevant to, and to engage, members of a mutual than a financial overview, and presents a clear opportunity to demonstrate the value of the business model.

Issuing the strategic report in place of either the full report and accounts or the summary financial statement may well increase the likelihood of a member understanding the benefits of the organisation and/or to vote at the AGM. It would also be a positive signal to regulators on transparency, and in demonstrating value. Coupled with the revised Auditor's report (see the separate guidance note) this helps ensure the report and accounts provide a robust account of the performance of the business.

On the whole, the content of the strategic report does not represent a significant change from the current approach. We recognise that for some very small AFM members, where narrative reporting might currently be limited, the new requirements impose a greater burden. For this reason, AFM recommends that members adopt the requirements as soon as practical, though not necessarily for 2013 annual reports. *Association of Financial Mutuals, October 2013*

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[2] The duty of a director, as set out in s172 of the Act, is to *'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'*.

[3] S78 of the Friendly Societies Act requires friendly societies to lay their report and accounts before the AGM and to send copies to every member who asks for them. Where a member asks for friendly society accounts under s78, they must be sent the full accounts as there is no equivalent to the exception provided by companies' law (which now states a mutual company can replace the full report and accounts with the strategic report and certain prescribed supplementary material). If a friendly society currently sends out the summary financial statement, as a matter of good practice, there is nothing in their legislation to prevent them from replacing this with the strategic report.