Exposure Draft: Guidance on the Strategic Report

Submission from The Association of Investment Companies (AIC)

The Association of Investment Companies (AIC) welcomes the opportunity to respond to the FRC's Exposure Draft on Guidance on the Strategic Report.

The AIC is the trade body representing some 340 investment companies, managing assets of around £93billion. Our members are closed-ended investment companies, the vast majority of which are listed on the London Stock Exchange. Their business is to invest in a diversified portfolio of shares and securities, property and other assets to provide returns for their shareholders. Investment companies have a keen interest in the disclosure framework both in terms of their own corporate reporting and the information published by investee companies.

The FRC's Exposure Draft provides useful guidance for preparers of strategic reviews. It goes beyond the scope of the content requirements and encourages companies to use the new regulations as a *"catalyst …. to prepare more concise and relevant narrative reports"*. The AIC has long been concerned about the pressure for companies to make additional disclosures in their annual reports which risks creating lengthy all-purpose documents serving a wide range of stakeholders. The guidance's emphasis on the purpose of the annual report to provide shareholders with relevant information is welcome. It will be a very positive development if a company's annual report can be more closely focused on the needs of its primary audience. The guidance encourages disclosures to be shareholder-focussed and entity-specific. We strongly agree that this approach, if adopted, will lead to better reporting for the intended recipients of the document.

We have noted previously that we do **not agree** that the disclosures should provide investors with *"information that is useful for making their resource allocation decisions"*. Annual reports should focus on a company's performance, financials and other key metrics. An investor's resource allocation decisions are investor specific: they will depend on the circumstances of the individual (their appetite for risk and spread of assets). These issues cannot be addressed in the company's own disclosures.

An important feature of the guidance is the practical recommendations for structural improvements in the annual report. Better cross-referencing, layering of information, use of visual tools such as tables, graphs and pictures, inclusion of glossaries and appendices, transfer of detailed information to separate documents or online, will make the document easier to follow, allowing readers to extract key messages without losing the ability to obtain more detailed information if required.

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

Illustration 1 is a useful overview of the components of an annual report. We **recommend** that the title of the first component - narrative reports - is changed because corporate governance statements could equally be called narrative reports. A suggested alternative is business reports.

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

The boards of most investment companies are made up entirely of non-executive directors. The stated objectives for the Directors' Remuneration Report only refer to executive remuneration policy. However, the regulations also apply to non-executive directors. For example, SI 2008/410 Sch 8 requires the report to contain a statement of the company's policy on directors' remuneration, which would include both executive and non-executive directors. This is not currently reflected in Illustration 1.

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?

We broadly **support** a 'core and supplementary information' approach to the structure of the annual report. Transferring certain detailed information to appendices, separate documents or the company's website could help reduce the length of the annual report and improve its structure. It could make it easier for readers to locate key information and effective signposting will enable them to retrieve further details where they are of interest.

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

The AIC agrees that the strategic report should focus on material information. Defining materiality according to whether an omission would affect the economic decisions of a shareholder is reasonable. It will help to ensure that the strategic report only covers issues which are of critical importance to shareholders. It will encourage companies to keep the strategic report short and concise.

Paragraph 5.3 is of particular importance. It provides useful application to the condition 'to the extent necessary for an understanding of…'. It provides an additional filter which enables companies to exclude information which might otherwise be disclosed in the strategic report.

We **recommend** that the meaning of 'these requirements' in the first sentence of paragraph 5.5 is clarified. It is unclear whether it relates to paragraph 5.1 or paragraph 5.4. Assuming the latter is correct, it is a helpful conclusion that the number of disclosures resulting from the terms 'key' and 'principal' are likely to be relatively small. This is useful for companies determining whether certain information should or should not be provided in the report.

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?

The communication principles set out useful benchmarks for producing a strategic report.

Paragraph 6.7 recommends that the strategic report is ‘neutral’. We do **not agree** with this concept. The board should be able to deliver positive news, for example where performance has exceeded expectations and all KPIs are better than anticipated, without having to search for negative points to balance the report.

Paragraph 6.15 refers to the Companies Act requirement for the report to be comprehensive. This is confusing because it potentially conflicts with the recommendations in Section 5 on materiality. We **agree** that disclosures should be limited to information which is focused, relevant to shareholders and important to the entity as a whole helps to scale back any temptation to produce a more complete register of disclosures.

The statement in paragraph 6.17 that a forward-looking statement is not the same as a forecast of future results is useful in relation to the liability regime applied to the directors of a company. It will enable directors to be more confident in the statements that they make.

We **agree** that information on the same or similar topic(s) which emanates from different disclosure requirements may be more clearly presented if it is located together. This will allow shareholders to get the ‘complete’ story on a particular issue rather than acquiring the information piece-meal.

The inclusion of practical suggestions such as a glossary of industry terms and better use of tables, graphs and pictures makes it easy for readers to adopt the communication principles.

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 agree with the guidance in paragraphs 6.26 and 6.27. However, the need for an appropriate structure and presentation of information outweighs the need for year on year comparability. Each annual strategic report will tell a different stage of the story. If readers want to go back to previous years, the critical point is that they can easily find and understand the information they require rather than the format looking the same.

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?

The AIC has no comment.

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?

It is sensible to align the definition of business model with the UK Code. This ensures a simpler disclosure regime and avoids confusion by preparers and users.

An investment company is required by the Listing Rules to publish an investment policy in its annual report which contains information about the policies it follows on asset allocation, risk diversification, and gearing, along with its maximum exposures. This investment policy equates to the company's business model and is likely to follow the guidance on business models.

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?

Yes, the draft guidance is sufficiently clear and can be adapted to the specific features of investment companies.

Each investment company has a defined investment objective which is set out in the company's prospectus and reproduced in each annual report. The investment objective is a short statement about what the company's overall purpose is. For example, the investment objective of a major investment company is *"to secure long-term growth in capital and income through a policy of investing primarily in an internationally diversified portfolio of publicly listed equities, as well as unlisted securities and private equity, with the use of gearing"*. This investment objective sets the company's specific goals about what it wants to achieve and therefore meets the definition of 'objectives' in Appendix 1.

An investment company already sets out in its annual report its plan or approach to achieving its investment objective. This might be, for example, whether it appoints one or more external manager(s) to run the portfolio or whether it employs internal staff to perform this function. It therefore already describes its 'strategy' as defined in Appendix 1.

As explained in Question 8, an investment companies investment policy equates to its business model.

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?

Many of the linkage examples would not apply to an investment company given its unique features. In practice, the ability to provide useful links will depend on a company's individual circumstances and disclosures. However, the examples help to demonstrate in principle how relationships and interdependencies can be highlighted in the report.

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