futurevalue
Broughton Down Farmhouse
Nether Wallop, Stockbridge
Hampshire SO20 8DS
T: +44 (0)1794 301189
E: info@futurevalue.co.uk

15 November 2013

Ms Deepa Raval
Financial Reporting Council
Aldwych House 71-91
Aldwych
London
WC2B 4HN

Dear Ms Raval

**Re: Exposure Draft: Guidance on the Strategic Report**

We are pleased to have the opportunity to submit a considered response to the consultation on the 'Guidance on the Strategic Report'. A brief introductory explanation of the authority that underlies our response will provide a background to our subsequent comments.

FutureValue is a specialist corporate reporting services firm that has been analysing and evaluating the quality of strategy related content in the Annual Reports of FTSE100 and FTSE250 companies since 2005, as well as quoted companies in other jurisdictions. Our comprehensive work over eight years has established a broad correlation between the quality of strategy and the market performance of quoted companies. For my own part as Director of FutureValue, I am the past Chairman of the highly regarded thought leadership body, the Strategic Planning Society, and have published extensively on business futures and leading-edge management topics, particularly business strategy. I am also an FCA and Cranfield MBA. We submit that as a firm we are probably better informed and qualified to comment on this particular Guidance than most other respondents.

Our detailed comments conform to the requested structure by numbered question within section. Preceding these are three important overall observations that also inform many of our subsequent detailed comments.

## 1 Overall observations

1.1 Summary (iii) states that: "*In practice, an annual report comprises three distinct components – narrative reports; corporate governance statements; and financial statements. The information contained in these components has different objectives which should guide preparers to where disclosures could be located*." We believe this enshrines a silo approach to important content that is not yet specified in the Strategic Report. Strategy is about process and governance as well as about the content, and a strategy is only good if it is well executed. The Strategic Report [SR] focuses on the content of strategy while it overlooks the related governance processes.

The SR should include specifically discussion covering the role of the full Board in setting the strategic agenda, monitoring its implementation, and evaluating its performance against strategy. It should include outcomes and key decisions pertaining to strategy and its performance from Board meetings in the year. Leaving this information to stand alone in the CG Report is insufficient. Companies that do this well bring strategy to life for their investors and demonstrate strategic leadership. This linkage is vital to achieving the utmost investor confidence.

1.2 We are also slightly confused by the introduction of the word 'objectives' in the Guidance. While we would be among the first to agree that this word is core to an entity's articulation of its strategic thinking and application, there is absolutely no mention of 'objectives' in the new S414 of the *Companies Act 2006* or, for that matter, anywhere in *The Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013*. This seems to be at odds with the statement in the Draft Guidance that: "*The 'content elements' [ … ] do not go beyond the requirements set out in the Act …* " 'Business model' and 'strategy' are the only words from the strategy lexicon in S414 that relate to pure strategy-related content. In our extensive analysis of FTSE350 companies we have observed that a high proportion of companies may omit any meaningful objectives, referring to their objective in a meaningless manner as being solely 'to increase shareholder value'. For them this addition of 'objectives' by the FRC may be perceived to be an imposition by the regulator and certainly not defined by the policy setter. We submit that this inclusion in the Guidance needs clarification even if it is correct.

1.3 Some aspects of 'The content elements' (6.28 - 6.73,) and in particular (6.29 - 6.41), read as if the FRC is trying to supply distance learning strategy education to reporting companies within this Guidance. Some of this inferred strategy instruction is in some respects inconsistent and in other parts even questionable as to its correctness. We submit that it should not be the purpose of these Guidance Notes to try to teach strategy to reporting companies. If the FRC should deem it important to contain such instruction on strategy then that instruction should be correct and consistent. Many strategists would question the validity of what is currently included.

## 2 Detailed comments

### *Section 3 The Annual Report*

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

This is broadly helpful, although some of the wording of the aims of each Section of the Annual Report may need amendment pursuant to any revisions to 'the content elements'. The format does overlook core and supplementary issues and the placement of supplementary information – a concern to at least one of our clients. We have also the concern that this structure embeds a silo effect – for example around strategy-related governance as explained above. There is additionally a question of whether the separate section for Corporate Governance Report outside of the Directors' Report now invalidates the 'safe harbour' provision in respect governance declarations? This needs clarification.

*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 with the objectives of each component and section of the Annual Report, although some wording of these objectives may need amendment if the FRC were to agree with our recommended changes to some of the content elements as discussed below.

*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?*

There is insufficient explanation of what is meant by 'core and supplementary' and how this should be treated. How does 'core and supplementary' sit with 'materiality'? When is something supplementary not material? This is not wholly clear.

***Section 5***

*Question 4: Do you agree with this approach* [the application of the concept of materiality to the strategic report]*? Is the level of guidance provided on the subject of materiality appropriate?*

Please refer to our response to Question 3 above. If a piece of information is treated as 'supplementary' in order to make the Strategic Report concise, does that treatment make it immaterial? Should it be in the Annual Report at all? 'Supplementary' and 'Materiality' need to be explained more clearly if they are to be separate principles.

***Section 6***

Paragraphs 6.1 to 6.5 address 'The purpose of the strategic report'. There is no given question in the given 'comment template' that addresses these paragraphs. We have two comments to make in respect of 6.2:

- 6.2: it would be helpful to link the identification of risks more closely to the objectives of the entity: i.e. replace "*and how they might affect future prospects*" with "*and how they might influence the achievement of those objectives*". The wording will encourage reporters to concentrate on truly strategic risks if the guidance explicitly links principal risks to the achievement of objectives and not just to future prospects
- 6.2: It would be helpful if the analysis of the entity's past performance was 'in the context of main objectives and strategies'. Good strategic management is about where a company has been and where it is, as well as where it is going. Report users can only really discern strategy in action from explicit linkage of performance to strategy components.

*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?*

These 'communication principles' seem comprehensive and include all we would expect to see. It would help to restate that the Strategic Report should address investors primarily, and should not aim to fulfil other peripheral purposes, such as being developed also as a marketing brochure to accompany contract tenders. There is also the issue of reporting companies producing a dual purpose SEC 20-F/UK regulatory Annual Report. This Draft Guidance studiously avoids any discussion of, or instruction on this issue. An indication that the Strategic Report within the Annual Report must meet all UK reporting requirements first and foremost, spirit and principle, would be a starting point and at least mitigate some of the worst dual purpose excesses.

*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?*

The point is well made. In many reporting companies where the Annual Report is not a valued communication, and there are a significant number of these we see each year, the structure of the narrative is remarkably unchanging year on year. The need for positive and active annual review will need enforcement.

*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?*

Our detailed comments follow in bullet-points with the respective paragraph number first:

- 6.29: The business model is not solely 'what the business does'. The business model is about the 'why' as well as the 'what'. This is implicit in the Code definition: "*the basis on which the company generates or preserves value over the longer term*" and requires analysis of why an entity will continue to be effective and necessitates evaluation of the external environment against the entity's internal realities. The business model is the foundation of, and precursor, to setting the goals, objectives and strategies of the entity. Sharman recognises this in his 'Going concern' recommendations and the FRC's Guidance on 'going concern', just as the Code does. A purely operational model as depicted in section 6.29 is of little value to the investor and confuses everybody. Sharman also puts the business model before the strategy
- 6.30: This is incorrect. An entity will decide on its business model and then sets its objectives and strategies to execute that model. The business model should explain what the entity does and why it is profitable and will continue to be so. The objectives and strategy indicate how the entity will then execute its business model effectively over time
- 6.31: Referring to our response to Question 9 below, "*a description of the entity's principal objectives*" should read "*a description of the entity's goals and quantified objectives*"
- 6.32: As above, "*An entity will normally have set a number of formal objectives*" should read: "*An entity will normally have set formal goals and quantifiable objectives*"
- 6.33: This should read: "*The disclosure of the entity's goals and the reason for them ...*" Objectives are usually the operating objectives and rarely confer strategic direction.

- 6.34: Financial objectives are the outcome of an entity pursuing its strategic non-financial business objectives. Non-financial objectives are central not incidental – "*should also be disclosed*". Financial objectives cannot alone confer strategic direction
- 6.35: "*The description of an entity's strategies allows shareholders to assess the current and past actions*" is not wholly accurate, we submit. Shareholders will only be able to assess current and past actions if the entity discusses its performance for the period in terms of its extant objectives and strategies
- Linkage example under 6.36: We recommend that the linkage example should read. "*The operating priorities or objectives for the main business segments should indicate how the entity's strategic direction cascades to the segments*"
- 6.37 to 6.41: These paragraphs that are more helpful in terms of defining the business model should come before 6.29
- Linkage example under 6.43: We submit this needs to be re-worded as: "*The rationale underlying the entity's business model and its consequent selection of goals and objectives may be clarified through a linkage to a description of trends and factors affecting an entity.*"
- 6.50: In line with our comments re 6.2 (c) we submit the first sentence to be: "*The risks and uncertainties included in the strategic report should be limited to those considered by the entity's management to be those likely influence the achievement of the entity's objectives.*" This will help to position the focus of principal risks and uncertainties on strategic factors
- 6.60: This needs close integration with the strategy of the entity and the underlying strategies of its main business segments: "*The strategic report should provide an analysis of the development and performance of the business in the context of its strategy applied during the financial year and of its position at the end of that year.*"
- 6.63: This section needs to be expanded. Strengths and intangible resources influence directly 80% or more of the market value of an entity on average and an even higher percentage for knowledge intensive businesses. The guidance would do well to expand on this section with some suggestion as to how a reporting company should aim to cover the range of intangibles and value drivers that will underpin its required strategic capability going forward.
- 6.66: This paragraph is in danger of marginalising the essential social and environmental information relating to the business. An entity should aim to demonstrate the integration of social and environmental dimensions with the economic dimension in the core strategy of the business. This can only be demonstrated effectively and concisely in the Strategic Report – aimed primarily at investors.

The second part of Question 7 asks whether "*other 'content elements' should be included in this draft guidance.*" We have made the point that the revised statute does not mandate 'objectives' and that FRC has included them in their Guidance. Best practice will always exceed the required regulation-defined compliant standard, particularly among those companies that recognise the benefits that accrue from the very best narrative reporting. If this were to mean that the FRC would consider the inclusion of other 'best practice ' topics we submit the following short list of candidates:

- An indicative strategic framework that shows graphically how all the elements should aim to link to create an integrated, logical and cohesive picture
- 'Goals' as well as 'objectives' – see response to Question 9 below
- Strategy-related governance processes – a record of the full Board's engagement in setting/reviewing the strategic agenda; assessing the risk profile; monitoring strategy implementation; evaluating strategic performance through KPIs and PIs
- Segment 'operating' objectives and strategies for the main business segments as well as 'corporate' strategy of the parent or group – to show the cascade

*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?*

Paragraphs 6.37 to 6.41 are adequate but are at odds with paragraph 6.29 and 6.30. The Code definition implies a strategic business model that is the fundamental rationale and the foundation of the entity's strategic framework. One needs to understand how a business will create value and is likely to preserve value over the long term (Code definition) before one can set the goals of the business, its objectives and its strategies. Note that we have appended to this response document our Business Model Development Guidance Notes prepared for our clients. These Guidance Notes include case examples from three sectors.

*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 have addressed this issue on detailed points in answering Question 7 above. Strategy-related language and terminology are important and need to be used carefully, correctly and consistently. There are varied uses of strategy terms in this Draft Guidance that are open to misinterpretation. FRC needs to provide a glossary of what it means for each of these and not just assume that they will have the same meaning for everyone. Specifically, the Guidance uses the word 'objectives' to mean what "*it* [the entity] *intends to achieve*". This is too general and fails to provide an important differentiation between 'Goals' and 'Objectives'. Strategists differentiate between the two as follows: 'Goals' are a general statement of aims or ambition; 'Objectives' are quantified operational statement of goals, not 'what the business wants to achieve'. Also, the word 'Strategies' is used as a general term to reflect all strategies, without recognizing the key difference between the 'Corporate Strategy' of a parent entity and an 'Operating Strategy' of the main business segments. The varying interpretation of 'Business Model', between an operational model more favoured by accountants and a strategic business model more favoured by investors and strategists, is another vexatious example. We recommend that FRC fixes on what it means in its use of strategy terminology and adds a glossary. This shared understanding will benefit all. If auditors were to use and apply accounting terminology and conventions loosely in a similar lax manner there would be severe ramifications. FRC needs to be more precise and authoritative in its use of strategy-related terminology.

*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?*

In our opinion the linkage examples are rarely examples, they merely offer additional optional illustrative guidance relating to the adjacent paragraphs. They are useful but their contribution presently is more to a sense of fragmentation of the Guidance Notes. It might be more helpful to list in a separate Appendix a wider ranging list of topics that illustrate linkage, showing them as a list of four columns comprising: the specific topic; where it resides as core, material information; what it links to in this illustration; the rationale for the linkage. This would confer greater appreciation of linkage as a principle, in our opinion.

We consider the final published version of Guidance on the Strategic Report to be of paramount importance in engaging reporting companies and in encouraging them to higher standards that will benefit significantly both their stakeholders and UK plc. Our experience on this is more apposite than most, which is why we have invested considerable time in preparing our response to the consultation. We hope that the Financial Reporting Council will recognise the merits of our observations and comments. We will be pleased to expand on these as required.

Yours sincerely

Ian McDonald Wood FCA MBA
for and on behalf of FutureValue

Encl: Business Model Development Guidance Notes

# BUSINESS MODEL DEVELOPMENT GUIDANCE NOTES

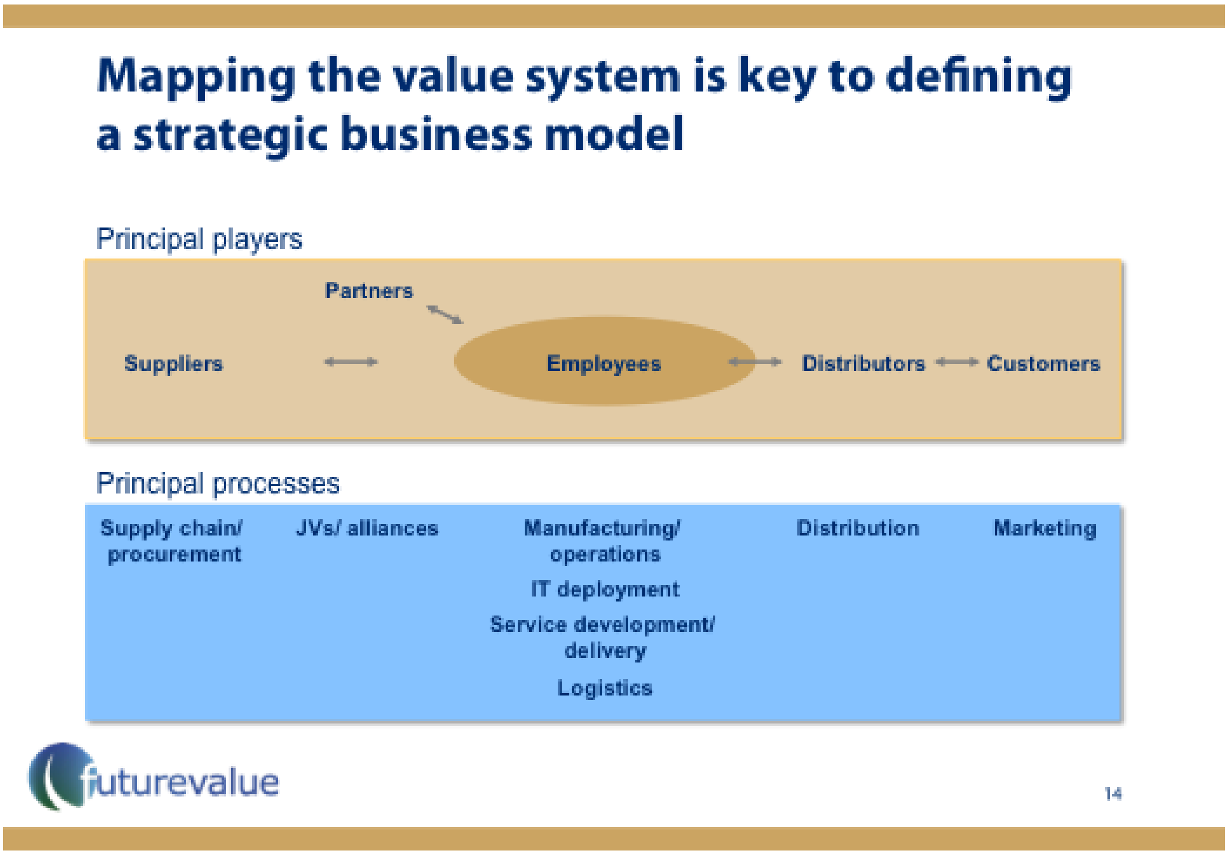
## Defining the business model

The business model is, as the name implies, a model, not a process. It should form the foundation for the strategic framework as defined here by FutureValue:

> *"The business model is the foundation of a company's strategic framework and defines the logic of the business. It explains why the business exists, and why it will continue to exist. It requires the business to understand the sources of competitive advantage that contribute to its profitability across the whole value system of the enterprise. A well-defined business model then enables the development and articulation of clear and consistent corporate goals, objectives and strategy."*

## Constructing the business model

Constructing the business model needs certainty about the make-up of the business before drafting can commence. It needs an informed and objective external focus with knowledge of the business in the context of its markets, competitors. It requires also knowledge of all the economic stakeholders to map the value system.



It is important to agree first what 'value' and 'value system' mean. 'Value system' refers to the full span of stakeholders engaged in the production and delivery of an entity's product and services, from the end customer right back to the furthest removed supplier. Much of the value system is typically outside the entity's organisational boundaries. 'Value', or sources of 'value', refers to activities that enable an entity to charge ultimately a premium for the product or service that it is providing. 'Value' thus created through these activities may be real and tangible, e.g. product quality, service delivered, efficient operations, reliable procurement; or, it may be perceived and intangible, e.g. brand, relationships, knowledge, convenience, culture etc. The most important sources of value creation usually* focus on the customer but relate to any player in the value system. To identify principal sources of value requires the development of an external perspective of the entity and what confers ongoing competitive advantage.

* **not** where the entity is a 'price taker' as, for example, in natural resources exploration and production

The following six steps will complete the initial analysis stage that must precede the drafting and articulation of the business model:

1 What is the business's value system and who are the principal stakeholders/players across the value system, i.e. customers, distributors, employees, partners, suppliers?

2 What are the principal processes in the value system, i.e. supply chain, manufacturing, operations, IT, logistics, marketing, distribution, etc.?

3 Referring to customers and markets, what are the distinct sources of value they perceive that give competitive advantage, i.e. why do they buy and why do they continue to do so?

4 Referring to other external stakeholders, what are the distinct sources of value they perceive – why do they partner with the entity, why do they joint venture or why do they distribute its products?

5 Referring to the principal processes, in what ways is the business continually investing to develop or maintain distinct advantage, e.g. innovation, systems, processes, knowledge etc.?

6 What is distinct about the treatment of that portion of value created accruing to the business in enhancing the business' sources of advantage, e.g. re-investment and focus of that re-investment, profit sharing, distribution to shareholders?

## Developing the business model for a group of entities

Most quoted companies will comprise a number of business entities or reportable segments. The Group business model will show how the Group adds value to its underlying parts. It requires the following steps:

1 Repeat steps 1 to 6 above for each reportable business segment

2 Referring to the list of distinct sources of value – value perceived, created and in development – identified for each entity or segment, look for the common shared sources of value across all entities

3 List and distinguish the sources of value that emanate customers and markets and separate them from those sources of value that relate to investment internally in strengths and resources

So, where a Group of business units is addressing a heterogeneous set of markets, where customers are not shared, the emphasis in the Group business model will be more on distinct sources of value created across the Group relating specifically to resources – e.g. innovation, knowledge, systems, productivity. Where a Group of business units is addressing more homogeneous and shared markets from that Group's perspective the emphasis will be on sources of value perceived – e.g. brand, relationships, service, accessibility, product range, quality. The output of the Group business model should show unequivocally how the Group as a whole adds value to the sum of the parts that are the underlying individual entities or segments.

## Articulating the business model

Whether a single entity or a group of entities/segments, the format and layout should be similar. Four relatively short paragraphs should be sufficient to capture the model comprehensively.

1 Describe concisely what the Company does, or what the Group and its segments do

2 Explain the primary sources of value created and as perceived by customers and markets; if this is a Group with heterogeneous non-shared markets across its segments there may not be any collective 'group' added value of this type

3 Explain where the Group/Company is investing internally and developing internally driven sources of value to give itself an edge; explain also the value created through other external stakeholders upstream in the value system

4 Explain the portion of value that becomes available for the owners of the business. How is value captured for re-investment, profit share for employees, distribution to owners.

## Example Business Models

Below are three example business models, each in four paragraphs based on the above – core business and needs met; the value created distinctively; the value being developed advantageously; and, the value captured as a result:

### *A Bank*

*"XYZ Bank is a UK based financial services group that meets the financial services needs of individual, commercial and corporate customers across the UK, with a range of banking, insurance, investment, debt financing and risk management products to meet those customer needs.*

*Fundamental to its success is its complete focus on customers and the advantages accruing from this focus. Products matched precisely to customer needs, iconic and distinct brands, multi-channel access and truly customer-oriented employees combine to provide the foundations for strong and enduring customer relationships.*

*Equally important are the Bank's growing cost-based advantages developing throughout the entire organisation and across its value system. These are to be found in the increasing efficiency of operations and processes, making the bank much better able to address its customers' needs. They are also becoming visible in simpler structures leading to greater agility of the organisation, effectively bringing the bank closer to its customers. These advantages even extend to streamlining how the bank works with its suppliers to help deliver services to customers more effectively.*

*A more intense focus on how the Bank creates and delivers value means it can now be more certain about the portion of value that it captures. This enables XYZ to strengthen its balance sheet, continue to invest in value for its customers and, in due course, achieve returns for shareholders sustainable over time."*

### *A Telecommunications Group*

*"Telecoms Group [TG] meets a wide range of communication services needs: for consumers; for businesses large and small, global as well as UK-focused; and for other UK communication providers.*

*As the leading provider of broadband, fixed line, networked IT and wholesale telecom services TG applies its knowledge, skills and experience to the distinctive benefit of its customers. In particular customers enjoy an* *increasing level of service and experience because TG learns faster than its competitors how to do things better for its customers. This includes bringing new ideas, products and services to market faster, cheaper and more effectively. It also means customers value us for what the TG brand stands for: being trustworthy, being helpful, inspiring and straightforward.*

*In addition to the benefits customers both perceive and enjoy TG is able to transform the costs of, and ways in which it provide its services. TG is building a better value system – by using IT systems more effectively and driving savings from suppliers, to streamlining internal processes and introducing new ways of working. In this TG Is applying organisational creativity and innovation to be more effective as well as more efficient. It is not surprising then that the Group has been able to deliver a 7% reduction in net operating costs.*

*Real value creation for customers and better value delivery across the TG value system add up to more value captured in the form of better profitability and increasing cash generated. It means more to invest in TG's future and in core markets, each a focus of one of the Group's strategic priorities."*

### *A London Market Insurer*

*"LM Insurer meet the needs of clients from around the world who want the security of insurance cover to help them manage complex risk exposures. These clients may also be insurance carriers. As a participant in the unique risk-sharing Lloyd's insurance market in London we are able to develop access and distribution to clients with these needs through the global span and reach of an expansive broker network centred on the Lloyd's market.*

*'LM Insurer' applies distinctive skills and capabilities to be able to address these client needs. As a specialist underwriter we have developed the ability to balance a portfolio of these complex risks to optimise the use of our capital. To achieve this we have developed expert know-how to underwrite and manage complex risks for profit. This requires the best talent in the insurance industry and, above all, entrepreneurial underwriters empowered and skilled to respond quickly to clients and to brokers. It also requires the ability to blend the face-to-face relationships, still essential to success in the Lloyds' market, with effective use of technology.*

*How we use and allocate capital is a prime capability and another key source of advantage. Our role as a leading participant in the Lloyd's market is an important aid to the agility we need to share risk and use capital in the most efficient and effective manner. We share risks with other Lloyd's participants. We also retain a high proportion of the risks we write to ensure we understand our clients. Central to our business model, risk sharing is an important tool to help us balance risk appetite, use our capital well and develop understanding of our clients' businesses.*

*Our knowledge of our markets and the value we create, our organisational capabilities and the skills we apply, and our highly attuned risk-sharing combine to ensure we underwrite more premium and have more invested assets per dollar of capital than our peers. It means we can aim to target an average combined ratio of 90% with low volatility."*

Note that a good Annual Report designer should be able to present the model, once clearly defined, in a simple, effective schematic. The definition and exposition has to come first.

Ian McDonald Wood
September 2013