Response of the Institute of Business Ethics to the Financial Reporting Council consultation on Guidance on the Strategic Report

The Institute of Business Ethics is a charity supported by business, whose purpose is to promote high standards of business practice based on ethics. Current subscribers include leading FTSE 350 companies, as well as several overseas entities. The IBE is an independent organisation and does not lobby on behalf of business. Instead it seeks to assist with the understanding and implementation of high standards of corporate behaviour, with the objective of promoting trust in business generally.

Reputation risk is an issue of growing importance for business. We therefore support the efforts of the FRC to promote high quality narrative reporting aimed at reassuring shareholders and other stakeholders that the company is aware of the risks and opportunities inherent in its interaction with broader society. Done properly, this should set out a context for the financial numbers and enhance readers' understanding of the business. In particular we strongly support the views set out in the document on materiality, balance and conciseness.

The business model is at the centre of a good narrative report. All narrative reporting should be relevant to the business, its current condition and future prospects, but unless boards can articulate their business model, it is hard to see how this can be the case. We broadly support the definition of business model set out in the appendix and in paragraphs 6.38 to 6.41 (question 8). The key issue is what drives value creation, but this does not come out clearly from the definition of business model as "what the company does" set out in paragraph 6.29 (question 9), which ignores the concept of value creation in its description of objectives and strategy.

Under the para 6.29 approach a motor distribution company might say that 'what it does' is sell cars. But this is not necessarily how it creates value. The main value drivers may be sales of vehicle-related insurance or the establishment of a continuing relationship with customers through servicing. If this is the business model set out in the strategic report, a reader will have a much better understanding of the business, how to judge the risks and how to read the financial numbers. The risks will include mis-selling of insurance. Understanding of the financial results will require attention to the margins on servicing as well as the customer retention rate.
A report which recognises this will give a reader much greater insight into the business.

We therefore suggest paragraph 6.29 should be revised. It should include specific reference to value creation. This involves explaining not only *what* the company does, but *how* it creates value. This is different from strategy which could be seen simply as the approach it has chosen to achieve its objectives. It runs deeper than aspiration and needs to encompass the essential character of the company so that the reader has a full understanding of the basis on which it competes.

This needs to include reference to the values framework that underpins its business model. A business model that depends on extracting value from customers rather than delivering value to them is less likely to be sustainable in the long run. How the company treats its customers matters, therefore, and by extension it matters also how a company treats its other stakeholders. We therefore recommend that the FRC considers adding to the guidance a provision requiring companies – on a comply-or-explain basis – to state whether they have a code of ethical business conduct, to describe the values on which it is based and to state how the board monitors compliance, including whether the company publishes each year the numbers of employees who have been dismissed for serious breaches in the code.

This provision should not impose an onerous additional burden on companies. Our research show that 96 out of the current FTSE100 already publish an ethical business code of conduct. A specific recommendation that this should be covered in the narrative report would act as an encouragement to companies that do not do so, complement the analysis of risk and how it is mitigated, underline the importance of good corporate behaviour and provide some context for the data on environment, employees, human rights and diversity that are now required under the law.

05/11/13