Climate Disclosure Standards Board

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Dear Ms Raval,

Exposure Draft: Guidance on the Strategic Report (August 2013)

Thank you for the opportunity to comment on the draft Strategic Report guidance, which we will refer to throughout this response as "the Guidance". This response represents the thoughts and opinions of the CDSB Secretariat hosted by CDP, but not of the members of any of CDSB's governance or technical committees.

Purpose-focussed reporting

The FRC's publication "Thinking About Disclosures in a Broader Context", to which we will refer throughout this response as the "Broader Context" document, cited the "need for disclosures contained within financial reports to be re-focused on their purpose." We very much support that sentiment and believe that much of the "clutter" in corporate reports generally and in the annual report specifically is attributable to the absence of a clear purpose for reporting. We are therefore surprised to see that the purpose of the Strategic Report is not clear from the Guidance. The Guidance says that the Strategic Report and the Regulations are designed to:

- Provide shareholders with a holistic and meaningful picture of an entity's business model, strategy, development, performance, position and future prospects (Guidance Introduction (i)) and to "ensure that relevant information that meets the needs of shareholders is presented in the strategic report" (Guidance Section 1 1.1);
- Be a medium of communication between a company's directors and its shareholders (Guidance Summary viii);
- Act as a catalyst for entities to prepare more concise and relevant narrative reports (Introduction (v)). Narrative reports include the Strategic Report and the Directors' Report according to paragraph 4.1 of the Guidance;
- Enhance the quality of narrative reporting more generally (Introduction (v)).
- Provide information on the entity, insight into its main objectives and strategies, the principal risks it faces and to complement, supplement and provide context for the related financial statements. (Summary (v));
- Set out high level principles that enable entities to "tell their story" (Summary (i).
- Encourage preparers to consider how the strategic report fits with the annual report as a whole" (Introduction (v)).

Whilst these are valid, they are too general to be applied by preparers as tests that they have satisfied the purpose of the Strategic Report. Furthermore, they are not significantly different from the purposes of management commentary, the business review, corporate governance and financial statements as shown on pages 16 and 17 of the Broader Context document. As paragraph 28 of the Guidance states, "the purpose and required content of the strategic report does not differ significantly from that of the business review which it replaces." This being the case, it is difficult for us, and we imagine other readers, to understand what it is that companies should do that is new or different from their existing reporting practices. We do not think that the new or different purpose of the strategic report (compared with the business review) is well articulated when compared with existing requirements and that the imperative for disclosures to be focussed on their purpose is therefore lost.

Making sense of corporate reporting

In our view, the new and different purpose of the Strategic Report is lost or obscured in the Guidance because, contrary to the title of the document, it seeks to do much more than simply provide guidance on the Strategic Report. We think that the Guidance actually seeks to make sense of the annual report generally. There are multiple references to this objective in the Guidance, for example in Section 1.1.1(b) which encourages companies to experiment and be innovative in drafting their annual reports and in section (v) of the introduction, which aims to promote greater cohesiveness in the annual report through improved linkage between information in the strategic report and the rest of the annual report. This raises the question for us as to whether the Strategic Report is specifically designed to provide the cohesiveness that is apparently lacking, rather than to provide new information beyond existing requirements. Is that its real purpose?

Aiming to make sense of the annual report and to bring some order to corporate reporting is a laudable and important objective and one we fully support. However, if that is the purpose, we urge the FRC to be more overt about it AND to include in the Guidance relevant parts of the Broader Context document. The Broader Context document considers a disclosure framework that draws together the various strands of financial reporting, that are shown on page 6 of the document as including corporate reporting, financial reporting and financial statements, all of which are components of annual reports according to the Guidance.

We note the reference to Integrated Reporting in paragraph (vii) of the introduction to the Guidance. Whilst Integrated Reporting shares terminology, characteristics and content with the Strategic Report, we cannot understand why reference has not also been made to European proposals to amend the Accounting Directives or to the IASB's work on its Conceptual Framework or to the IFRS Practice Statement on Management Commentary, all of which ALSO cover the same or similar material to the Strategic Report. We are not convinced that BIS and FRC's desire for greater cohesiveness in reporting can be achieved until the obvious and subtle differences between Integrated Reporting, Management Commentary, the IASB's Conceptual Framework and the EU proposals on amendments to the Accounting Directives are reconciled or explained.

We are also concerned about the presentation of the Guidance as non-mandatory, principles-based material that encourages companies to experiment and be innovative in the drafting of their annual reports to tell their story. How will a preparer know whether and to what extent their application of the principles-based, non-mandatory Guidance, coupled with innovation and experimentation will meet compliance expectations? We wonder how the Strategic Report requirements will be enforced while the Guidance suggests that such a flexible approach to compliance is possible.

As the Guidance rightly points out, the differences between the Business Review and the Strategic Report are minimal. The non-mandatory, principles-based character of the Guidance, which encourages experimentation, makes us wonder about the overall purpose of the Guidance as a mechanism for helping companies to obey a legal requirement which is not significantly different from existing law. We think that either the Guidance should either be about making sense of the annual report OR about implementing the small differences between the Strategic Report and the Business Review. At the moment it seems to masquerade as the latter whilst dealing with some aspects of the former.

Questions 1 – 3: Section 3 The Annual Report

Introductory remarks

We have no objection to the stated purpose of the annual report as set out in paragraph 3.4 - "to provide shareholders with relevant information that is useful for making resource allocation decisions and assessing management's stewardship." However, we encourage the FRC to consider the implications of using the term "stewardship" in this context. In particular:

- The Regulations at paragraph 414C (1) state that the purpose of the Strategic Report is to inform members of the company and to help them assess how the directors have performed their duty under section 172 of the Companies Act. This is also confirmed in paragraph 6.1 of the Guidance. Adding "stewardship" to the definition of annual report seems to add a new responsibility or dimension or meaning to the duties imposed on directors under section 172 of the Companies Act. If the term stewardship is not defined, we struggle to understand how a director will know when stewardship has been exercised in satisfaction of the Strategic Report requirements.
- Page 17 of the Broader Context document seems to suggest that stewardship "belongs" under the corporate governance component of reporting and action. As noted in paragraph 3.9 of the Guidance, paragraph C.1.1. of the Corporate Governance Code requires directors to state that they consider the annual report, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the company's performance, business model and strategy. The Guidance claims to aim for consistency with the Code but, again, adding stewardship seems to take the requirements further than the Code envisages. The Code refers to the system of corporate governance as including stewardship (paragraph 2 of the Code) – it therefore seems to apply only to one component of the annual report, not to the annual report generally.
- As you are aware, EFRAG and others have pointed out the controversy about whether accountability or stewardship should be an explicit requirement of reporting. Their report "Getting a Better Framework – Accountability and the Objective of Financial Reporting" refers to the IASB's apparent decision to avoid the use of the term stewardship. We would suggest that if BIS and FRC are aiming to encourage linkage between the different components of the annual report, agreement with the IASB, whose work is used to prepare elements of the annual report, on the use of the term stewardship would be helpful.

We very much support the notion of reporting being used to satisfy readers that directors are exercising stewardship over the inputs to the business, as well as the activities of and outputs and outcomes from the business. However, we advise refraining from the use of the term pending consultation with other organizations looking at using reporting to prove stewardship AND until such time as the term can be defined consistently by all relevant organizations AND it is clear what a company needs to do and report in order to claim that it has exercised stewardship.

Question 1 – is Illustration 1 in Section 3 helpful in achieving the objective of clarifying each part of the annual report?

We do agree that Illustration 1 is helpful in identifying the components that often appear in the annual report. We also found the Disclosure Themes set out on pages 16 and 17 of the Broader Context document helpful. The two depictions of the elements of disclosure have some things in common. We think it would be helpful to combine the two in a single illustration, as the combined version would show how management commentary fits into the annual report. As explained on page 16 of the Broader Context document, management commentary includes the business model, resources, risk and relationships, objectives and strategies, results of operations and prospects, external environment, critical financial and non-financial performance measures and indicators and uncertainties, all of which are very similar to the content required by the Strategic Report. We are not clear where management commentary fits into Illustration 1 and whether it wholly or partly forms the Strategic and Directors' Report. It would be helpful if that could be clarified in a revised Illustration 1.

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

We are concerned that paragraphs 3.2 – 3.3 refer to the three components of the annual report as having different objectives. We think that they have a single objective and should be presented as such. The single objective is well articulated in paragraph 3.4 of the Guidance, subject to our comments above on the use of the term "stewardship". This SINGLE objective is served by the provision of information about the company's strategy, objectives, risks, etc., per the Strategic Report AND about the company's governance practices AND about its financial position, per the Financial Statements. We do not think that BIS and the FRC will achieve the kind of cohesiveness they desire unless and until the annual report serves a single objective for a single audience, albeit that the single objective and audience may be served by multiple types of information in different parts of the report. We therefore suggest that the row entitled "component objectives" is described as something like "contribution of component to annual report objective". It would therefore be clear that each component, whilst focussing on a different aspect of the entity, serves a single objective.

Question 4 – Materiality

Materiality is a notoriously difficult subject in the context of reporting and BIS and FRC are not alone in dealing with the challenges it presents. Our observations and suggestions are as follows:

- We very much support the statement on paragraph 5.7 that materiality tests should not be applied to disclosures that are required by law EXCEPT where the requirements apply only to the extent necessary for an understanding of the business. It is a common misconception that materiality is used to determine what is important in all cases. As paragraph 5.7 confirms, where information is required by law, it is by definition material.
- We understand materiality to be a "constraining" factor that should be applied for the purposes of determining how much relevant information should be disclosed. In paragraph 5.2 the Guidance says that a Strategic Report should only contain relevant information. We are surprised that there is not more guidance on determining relevant information. Materiality tests should be applied only to relevant information AND only where information is required to the extent necessary for an understanding of the business.
- We are not sure that preparers of Strategic Reports or indeed shareholders themselves always know what is material to shareholders and therefore the test at paragraph 5.2 of the Guidance is not necessarily helpful. Part of the reason for the emergence of new forms of reporting, including sustainability reporting, is that companies and shareholders have failed to recognise the environment and society as having a potentially material effect on the performance, position and development of companies.
- Rather than leaving preparers to determine materiality by second guessing what might be material to shareholders, we think it is much more helpful and direct to determine what and how much to put in a Strategic Report by reference to the objective of the report. The simple test then becomes – *if it meets the objective of the report, it must be disclosed*. Page 7 of the Broader Context seems to suggest something similar when it says - "we take the view that disclosures that do not meet the objective of financial reporting should be excluded from the financial report and that this would be a step towards making annual reports shorter and more relevant."
- Although not in the materiality section of the Guidance, paragraph 3.12 suggests that the "core and supplementary" approach has a purpose related to materiality. It says that the core and supplementary approach is intended to ensure that the most important information is given prominence in the annual report. We do not agree with the core and supplementary

approach. If something is supplementary according to the objectives of the Strategic Report, it should not, by definition, appear in the report.

Question 5 – Communication principles in paragraph 6.5 – 6.27

Subject to the comments below, we have no objections to the communication principles in paragraphs 6.5 to 6.27. However, we think that the principles could be made much more effective if they were reconciled by reference to similar principles already used for reporting as prescribed by the IIRC, the IASB, the EU and others.

We take serious exception to the requirement in paragraph 6.11 that the strategic report should be concise. As stated in paragraph 6.12, the important point is the Strategic Report should contain information that:

- is relevant, and
- meets the requirements of the law; and
- meets the objective of the annual report.

We strongly urge the FRC not to use the term concise unless it can be precisely defined AND the relationship between conciseness, the three bullet points above and comprehensiveness (paragraph 6.15 of the Guidance) can be fully explained.

Question 8 – The Business Model

We note that the Guidance has adopted the definition of "business model" from paragraph C.1.2. of the 2012 UK Corporate Governance Code as being the basis on which the company generates or preserves value. However, the terms value, value generation, value preservation and value capture are not defined in the Guidance or in the Corporate Governance Code. We struggle to understand how a company will know whether the description of its business model in a Strategic Report will satisfy the requirements if these terms remain undefined. Please also note that the definition in the Guidance and the Corporate Governance Code does not match the definition offered in the Integrated Reporting Framework which has the benefit of having been researched by reference to definitions already in the public domain.

Other comments on the Guidance

Page 8 Section 2 2.1

The summary of legal requirements could be more accurately re-worded as follows:

"Section 414A of the Act requires all companies that are not small to prepare a strategic report which contains the contents set out in section 414C, that is a fair and balanced review…." And cross refer to paragraph 6.1.

Page 26 paragraph 6.64

We suggest that the Guidance cross refers to DEFRA's "Measuring and reporting environmental impacts: guidance for business."

Relationship between the Strategic Report and the Directors' Report

We do not think that the Guidance deals in sufficient detail with the relationship between the Strategic Report and the Directors' Report and the extent to which the same type of information is arguably required by both and could appear in both. For example, we are concerned about the possible tension between:

- Paragraph 414A (3) of the Regulations, which requires the directors of a group that prepares group accounts to prepare a Strategic Report, including environmental information, for the undertakings included in the consolidation; and
- Part 7, paragraph 15(2) of the Regulations, which requires the Directors' Report to state the annual quantity of greenhouse gas emissions "for which that company is responsible."

As you will appreciate, there could be major differences between the organizational boundary around the undertakings included in the consolidation and the boundary of responsibility. We understand the reasons for this and applaud DEFRA's recognition of existing approaches to greenhouse gas emissions reporting. However, we believe that the Guidance must reassure preparers that if they include greenhouse gas emissions information in their Strategic Report as allowed by section 414C(11), it is acceptable for that information to be prepared according to a different organizational boundary and a different reporting period (see Part 7 paragraph 19) from the Strategic Report.

Conclusion

We very much support the development of guidance to help with implementation of the new Strategic and Directors' Report Regulations and hope that our comments are of some use in your future work. We would be delighted to assist with your work if you think that we can be of any help.

Yours sincerely

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Advisor, CDP

CDSB is an international organization committed to the integration of climate change-related information into mainstream corporate reporting. CDSB advances its mission by acting as a forum for collaboration on how existing standards and practices can be supported and enhanced so as to link financial and climate change-related reporting and respond to regulatory developments. CDSB develops its Climate Change Reporting Framework and guidance based on existing standards, research, analysis and good practice working in close partnership with leading professionals in accountancy, business, standard setting and regulation.

CDP is an international, not-for-profit organization providing the only global system for companies and cities to measure, disclose, manage and share vital environmental information. We work with market forces to motivate companies to disclose their impacts on the environment and natural resources and take action to reduce them. CDP now holds the largest collection globally of primary climate change, water and forest-risk information and puts these insights at the heart of strategic business, investment and policy decisions.