Aviva Investors' response to FRC's Exposure Draft: Guidance on the Strategic Report

Aviva Investors is the global asset management business of Aviva plc. The business delivers investment management solutions, services and client-driven performance to clients worldwide. We operate in 14 countries in Asia Pacific, Europe, North America and the United Kingdom and have assets under management of £250bn at June 2013.

The Strategic Report will be an important report upon which we can engage with companies on issues that will affect the long term value of the companies in which we invest on behalf of our clients.

We believe that better long-term investment returns come from companies that conduct business in a sustainable and responsible manner. Therefore, a key component of being a responsible business is how we act as responsible investors, which means including environmental, social and corporate governance (ESG) considerations into our investment process.

In the main, we believe the guidance is useful , helpful and appropriate. However, more guidance should be provided on sustainability reporting which is an area which is not as well developed in a strategic way. Developments from the IIRC and on mandatory GHG reporting are particularly welcome as our ultimate preference would be for companies to provide integrated reporting but in terms of FRC guidance for the strategic report, we believe it would be helpful for companies to have more specific guidance on available frameworks to ensure that material ESG are properly considered in a strategic way and not treated as an 'add on' to strategy. We would also welcome clearer guidance on what types of issues would fall under 'social'.

Our response is as follows:

Section 3: The annual report

Q1: Do you think that illustration 1 is helpful in achieving this objective?

Yes

Q2: Do you agree with the objectives of each component and section of the annual report which are included in illustration 1?

Yes

Q3: 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.

Section 5 Strategic reports and materiality

Q4: Do you agree with this approach? Is the level of guidance provided on the subject of materiality appropriate?

We believe the approach is generally sensible. It is helpful to readers to understand the company's approach to materiality and therefore it may be helpful for companies to confirm they have used the suggested IFRS definition of materiality in producing the strategic report or, if not, state what their approach to materiality is.

There is also no requirement to explain why an issue is material and the company's approach to ensuring that material aspects of the business are being addressed. In order for the strategic report to tell the 'story' of the business, materiality should be put in context to its sector, its markets, the economy, societal trends, regulation and its competitors.

Given the regulations do not refer to materiality and because the term has become so confused; the FRC may wish to consider using the phrase "business relevant". Analysts and fund managers will routinely want to consider data on issues that they consider to be business relevant, without each individual data point necessarily "materially" changing the buy/sell/hold outcome. This may be a useful concept here.

Q5: 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 would stress that preparers of annual reports should take this opportunity to ensure that the Strategic Report is an easy to read, interesting document that effectively communicates the (entity specific) uniqueness of the business. Companies should not be bound by the traditional reporting words and processes to replicate what they have always been doing and should aim to demonstrate its own individual character, values and culture in its own words.

The guidance in this section is generally helpful. However, a significant flaw in the guidance is the lack of information on how to produce a strategic report that is also a summary report. The strategic report does not require information on boards, the financial statements and only minimal information on remuneration. A summary report without these details would not be a helpful document to shareholders. The FRC guidance should have a section covering this. For example, the FRC could suggest that the Strategic Report structure should remain the same but that information on boards, remuneration and financial statements should be attached as appendices.

Without this guidance companies are likely to include this information into the text of the strategic report that will result in this report being much longer and include non material information.

Q6: 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?

Yes, but it may be helpful to re-emphasise the objectives of the strategic report again here.

Q7: 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?

6.33 says that the disclosure of the entity's objectives, and the reasons for them, gives an indication of the direction of the business and provides insight into its future development, performance and position. We would emphasise the need to provide this information in an external context as well as an internal one. That is, to also include its direction in the context of its particular market, sector, economic influences and how it intends to meet the challenges of competitors.

6.34 says that while some objectives may be defined in terms of financial performance, non-financial objectives should also be disclosed where achieving them is important for the entity's future development, performance and position.

We believe it would be helpful to supplement 6.34 with some additional guidance. For example, reporting on human rights is not well developed. Therefore proper guidance on human rights reporting is of key importance in raising standards, ensuring that the policy objectives of enlightened shareholder value are met and that directors do indeed pay more than 'lip service' to these issues. The guidance makes no reference to the UN Guiding Principles on Business and Human Rights which we believe is an omission given the Regulations require companies to report on human rights. In order to improve the guidance, the FRC could follow the example of the Global Reporting Initiative and provide directors with an indicative list of issues to consider in preparing their reports.

Other than references made to the IIRC and to DEFRA for greenhouse gas reporting, which is very welcome, the guidance does not make reference to any other frameworks. There are other frameworks which could be mentioned to help develop reporting on non financial issues such as the International Labour Organisation (ILO), Global Compact, the Global Reporting Initiative (GRI), Carbon Disclosure Project (CDP) and the Climate Disclosure Standards Board (CDSB). We would suggest that the Guidance also refers to development in the EU on non financial reporting.

6.36 says that where relevant, linkage to and discussion of key performance indicators should be included in any descriptions given in order to allow an assessment of the entity's progress against its objectives and strategies. Unlike the reporting standard created for the Operating and Financial Review, the FRC draft guidance provides no illustrative examples of potentially useful KPIs to help track progress in relation to social, environmental and human rights issues. The need for and usefulness of KPIs is not given sufficiently strong emphasis in the sections relating to social, environmental, human rights and reputational risks.

In 6.52 it says that Directors should consider the full range of business risks including commercial, operational and financial risks; it should also say 'social, environmental human rights and reputational risks'.

It is also important for the guidance to make clear that a parent company with a subsidiary undertaking operating in an area of political instability could face risks resulting from the activities of that subsidiary undertaking or its business relationships. Where the magnitude of such risks exist such that it would be material to shareholders (see definition of materiality 5.1), those risks together with details of action to manage or mitigate them should be disclosed in the strategic report. In addition, the strategic report should include information about, and a discussion of, the relevant KPIs and other information used to track performance.

6.65 provides linkage examples which is helpful. However, we believe there needs to be much clearer guidance on how ESG reporting in the strategic report is linked to the rest of annual reporting. It is important that social, environmental and human rights issues are presented as integral to discussions on strategy, risks and performance rather than treated as an afterthought or an 'add on' to corporate reporting. For example, perhaps the FRC can provide a linkage example linking ESG issues to a more detailed CSR report

6.68 describes the breakdown of information on diversity. We believe this should be accompanied by narrative about the pipeline and other relevant information that can put the diversity figures into context.

Q8: Appendix 1 '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?

Yes

Q9: 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

Q**uestion 10: The 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?**

It would be helpful to include an example of ESG linkage in the guidance.

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