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For the attention of Deepa Raval

Our ref djl/djw/815

Contact David Littleford
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18 November 2013

Dear Sirs

**Response to Exposure Draft: Guidance on the Strategic Report**

We are grateful for the opportunity to comment on the Exposure Draft: Guidance on the Strategic Report. We set out our main comments below and have responded to the specific questions in an appendix.

We agree with the FRC that it is important to support and encourage more effective communication between companies and their shareholders and other stakeholders, including in the annual report. We consider that encouraging best practice is preferable to a rules-based, compliance approach to the requirements. Therefore, we support the FRC issuing non-mandatory guidance to assist companies in their application of the new Company law requirements and the updated UK Corporate Governance Code.

The guidance in its final form will be too late for a number of the companies that are the first to apply the new requirements. To achieve the maximum effect as the requirements are applied for the first time, we urge the FRC to finalise this guidance as soon as possible after considering the responses received. We have made a number of suggestions to enhance the usefulness of the guidance in an appendix. However, given the urgent need for final guidance, if the FRC considers that expanding the guidance requires further analysis / consultation that would delay finalisation, we would support the issue of the guidance in its current form with a separate project to enhance it in due course.

We strongly support that the guidance goes beyond the strategic report itself, emphasising the linkages between narrative reporting and other parts of the annual report.

We agree with the shareholder focus of the FRC's draft guidance as we think it is essential that the audience for the strategic report is clearly defined even though other stakeholders in an entity are likely to be interested in its contents.

We welcome the references in the draft guidance to Integrated Reporting and the shareholder / investor focus of the guidance. We believe greater emphasis could be placed on the capital concept used in Integrated Reporting as a means of assisting companies to identify and address all material drivers of future business prospects.

We also believe that greater emphasis could be placed on the useful role that narrative reporting can play in supporting shareholders' assessment of fundamental business value (in addition to their assessment of management's stewardship). In this respect we believe that companies should be encouraged to make much greater use of non-financial Key Performance Indicators as possible leading indicators of future financial prospects and as indicators of progress in managing risks and opportunities.

We support the efforts made to enhance the consideration of materiality in the context of narrative reporting. We believe that materiality should be described consistently with the definition of materiality applied by the directors in preparing the financial statements that are also part of the annual report.

If you wish to discuss any of the points raised, please contact David Littleford on 0207 694 8083.

Yours faithfully

KPMG LLP

KPMG LLP

*Enclosures:*
*Appendix: Responses to specific questions raised in the exposure draft*

**Appendix**

**Responses to specific questions raised in the exposure draft**

**Section 3 The annual report**

*Section 3 of this draft guidance includes an illustration (Illustration 1) which is intended to clarify the purpose of each part of the annual report and help those that prepare annual reports to make judgements regarding where information would be best presented.*

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| Question 1:<br>Do you think that Illustration 1 is helpful in achieving this objective? |

We believe that the diagram helpfully summarises information that would be complex in paragraph form, though we do have some reservations. In particular, we are concerned that the section labelled "Corporate Governance statements" should separately identify each of:

- the general Corporate Governance statements;
- the Audit Committee report;
- the Directors' Remuneration report; and
- the Nomination Committee report.

We support that the illustration is both explained and heavily caveated in paragraphs 3.1-3 as we would otherwise be concerned that the illustration might be taken as the only approach (see response to question 6).

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| Question 2:<br>Do you agree with the objectives of each component and section of the annual report which are included in Illustration? |

Yes, subject to the response to Question 1 above. We suggest that it would be helpful in the *Strategic Report - section objectives* to expand the description of objectives to reflect the guidance provided in sections 5 and 6 and to support the annual report document purpose defined at the top of the table. Specifically we suggest amending bullets 2 and 3 (tracked changes shown):

- To provide an analysis of the entity's past performance <u>in order to (i) support an assessment of management's stewardship of the business and its resources; and (ii) provide an understanding of the current performance of the business as a starting point for assessing its future prospects</u>.
- To provide insight into the entity's main objectives and strategies, and the principal risks <u>and opportunities</u> it faces ~~and how they might affect future prospects~~ <u>as a basis for readers to assess the future prospects of the business and its ability to generate shareholder returns</u>.

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 believe that the guidance on the placement of information in the annual report in paragraphs 3.10 to 3.14, if adopted by preparers, will have a positive influence in making the annual report more understandable and relevant to shareholders.

**Section 5 Strategic reports and materiality**

*Section 5 of this draft guidance addresses the application of the concept of materiality to the strategic report, remaining as faithful as possible to the definition of materiality used in International Financial Reporting Standards (IFRSs).*

Question 4:

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

Overall we agree with this approach and consider that it is desirable that the guidance is as faithful as possible to the definition of materiality used in IFRSs. We note that the definition of materiality in “IFRS” which is given in paragraph QC11 of the IASB’s (non-EU endorsed) Conceptual Framework for Financial Reporting is very brief and further note that in UK GAAP additional guidance in provided within paragraph 3.28 to 3.31 of the Statement of Principles; the IFRS QC11 paragraph is very similar to just paragraph 3.30.

Although the guidance has been written with quoted companies in mind, who will mostly applying IFRSs (if they prepare consolidated financial statements), the guidance notes that it may be useful to other (unquoted) entities preparing strategic reports. Therefore it is appropriate that the guidance also remains as faithful as possible to the definition of materiality used in UK GAAP’s Statement of Principles. In this regard we note that the definition of materiality in the Glossary in Appendix 1 includes not only includes text drawn very closely from paragraph QC11 of the IASB’s Conceptual Framework for Financial Reporting and paragraph 3.30 of the FRC’s Statement of Principles but also includes text drawn very closely from paragraph 3.29 and more widely drawn from paragraph 3.31.

We also draw attention to the fact that the ICAEW has issued Tech 03/08 *Guidance on Materiality in Financial Reporting by UK entities* and recommend that you also consider that guidance to minimise any inconsistencies.

Finally, section 5 refers to the legally permitted exclusion from the strategic report of information about impending developments or matters in the course of negotiation which would, in the view of the directors, be serious prejudicial to the interests of the company. In many cases when detailed information is considered confidential, summarised information that is not seriously prejudicial may meet substantially all shareholder information needs. It may be helpful for the guidance to acknowledge that such summarised information should be used to provide such non-confidential information as can be reported when s414C(14) Companies Act 2006 exclusions are being applied.

While we support the intention, we are concerned with the statement that "Immaterial information should be excluded from the strategic report" (paragraph 5.1). It is highly unlikely that every piece of information in the strategic report is material as defined. It may be preferable to phrase the guidance consistent with the preceding sentence (i.e., "… can obscure…", not *does* obscure), for example, immaterial information should not be included in a way that obscures key messages.

**Section 6 The strategic 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?

We agree with these proposed communication principles on providing concise information that is focused on meeting shareholder needs.

However, we believe greater emphasis is needed on the role that the report should play in supporting shareholders' assessment of business value (based on the future earnings prospects of the business) – e.g., in paragraph 6.12.

We support the concept of linkages across the annual report as set out in paragraph 6.21 and note that the examples in the guidance are helpful. However, paragraph 1.4 also acknowledges that linkage exists within the strategic report itself, and we encourage the FRC to amend 6.21 to recognise this explicitly. We also encourage the inclusion of additional examples in the guidance of linkages that may exist within the strategic report contents – for example descriptions of business model and environment should link to descriptions of risk and opportunities which in turn should link to descriptions of strategy and performance in managing these matters.

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 believe it is essential to retain flexibility of structure within the strategic report to allow boards to describe matters in a relevant way rather than an imposed structure (see response to question 1).

We agree with content of paragraphs 6.26 and 6.27 and in particular the principle of annually reviewing the structure and presentation and that the directors should contemplate whether any proposed changes in the structure and presentation represents an improvement.

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 Companies Act 2006, 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?

We understand the approach that the FRC has taken. However, in a non-mandatory document we consider that additional guidance could be added as explained below. Guidance on these additional items could be clearly identified as "related" content rather than Companies Act elements.

Given the urgent need for final guidance, if the FRC considers that expanding the guidance requires further analysis / consultation that would delay finalisation, we would support the issue of the guidance in its current form with a separate project to further expand it.

First, the FRC should consider additional content elements as follows:

- External environment (as the context for the business model and risk disclosures).
- Performance (recognising the importance of explaining different components of business performance and explaining progress in implementing strategy / managing risks).
- Prospects (linked to the directors' report disclosure requirement of "an indication of likely future developments in the business of the company" (SI 2008 No 410 Schedule 7 paragraph 7(1)(b)).

Second, we believe that the discussion of some of the content elements that are being provided in the guidance can be improved. In particular:

- Trends and factors (paragraph 6.46) – To further assist preparers in this non-mandatory guidance, we suggest the inclusion of the capitals model used in Integrated Reporting is a good basis for helping to identify factors potentially affecting the capability of the business.
- Principal risks and uncertainties (paragraph 6.52) – Risks to the achievement of upside opportunities / strategy can be amongst the most significant risks in shareholders' assessment of value. We suggest that the guidance emphasises that these risks are equally important to downside risk.
- Key Performance Indicators (KPIs) (paragraphs 6.55 to 6.57) – In respect of KPIs:
    - KPIs should also be provided (i) to support an understanding of progress in managing identified risks; (ii) as leading operational indicators of future financial prospects.

- The term non-financial data is sometimes interpreted narrowly as relating to only Corporate Social Responsibility information. It would be helpful if the guidance clarified that this is not the intention in paragraph 6.55.
- Track record information covering 3 or 5 years is often more useful than just a single year comparative for non-financial KPIs when the important information is contained in the KPI trend rather than its absolute value.

- Paragraph 6.63 – We also note that the list of examples omits customer base which may be an important 'intangible' in many businesses. Perhaps this could be added?
- Paragraph 6.65 – This paragraph is applicable for all the items in paragraph 6.63 as well as those identified by statute in paragraph 6.64. As it stands it risks over-emphasising the items in paragraph 6.64.

Question 8:

Appendix I 'Glossary' uses the same definition of a business model as the UK Corporate Governance 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?

We believe that the guidance provided on the business model description in paragraph 6.38 can be improved. Business model descriptions need to provide sufficient context to support an understanding of the significance of matters identified in the other report content elements and the linkages with them (e.g., quantitative KPIs).

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 believe that, as the draft guidance acknowledges, these concepts are interrelated. Provided that all are addressed, it seems less important where the boundaries lie *vs* the precise terminology used. Therefore, subject to clarifications noted in answers to questions 7 and 8 above, the draft guidance differentiates sufficiently between the concepts of business model, objectives and strategies.

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?

Subject to our comments previously provided in our response to question 5 where we have suggested a broader application of the linkage principle (and hence more possible examples), we consider that the linkage examples that have been included in the draft guidance are useful.

However, the example given in paragraph 6.24 may give the impression that no further information is required if a matter is addressed in the financial statements (e.g., pension obligations). We suggest amending this example so it is clear that the linkage is provided in addition to other material information.