

CLT envirolaw response to the FRC Exposure Draft : Guidance on the Strategic report

General comments

CLT envirolaw's general comments are that the guidance provides useful high-level information for producing a strategic report, but there are some key aspects that are missing from the guidance. These are as follows:

- companies should be required to be transparent about their materiality process
- the materiality assessment process should be proportionate to the likely level of strategic business risk. Therefore each company must carry out some initial assessment of the strategic business risk from the angle of non-financial issues.
- companies should be informed about the benefits that active engagement with key stakeholders can have on understanding what to report on, and to what level, particularly in relation to non-financial information
- information, in particular KPIs, should be comparable (i.e Global Reporting Initiative)
- there are a number of reporting standards that should be signposted to help companies disclose non-financial information (e.g. GRI, IIRC, ISO 26000, UN Guiding Principles on Human Rights)

We have set out our comments as requested in the consultation – using the specific paragraph or groups of paragraphs to which they relate, contain a clear rationale and, where applicable, suggest an alternative approach or text.

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Section 3 of this draft guidance includes an illustration (Illustration 1) which is intended to clarify the purpose of each part of the annual report and help those that prepare annual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

Question 1

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

Yes

Question 2

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

Yes

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?

Yes

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Section 5 of this draft guidance addresses the application of the concept of materiality to the strategic report, remaining as faithful as possible to the definition of materiality used in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?

No. The guidance should recommend that companies disclose their materiality assessment process for both financial and non-financial information in the director's report and link it to the strategic report. The IFRS definition is high level and open to interpretation. It is important for investors and other stakeholders to understand the company's interpretation, and therefore why some information has been included or excluded.

The guidance should state that the level of a company's materiality assessment process is proportionate to the level of potential strategic business risk. Some companies face more strategic business risks from non-financial issues, and their risk assessment process should reflect this. Strategic business risks associated with non-financial issues can have a significant impact on the performance of the business as other issues, and the risk assessment process should therefore be as in-depth and complex. For example, if there are a number of potential significant business risks, then the company should consider actively engaging with investors and other stakeholders to gain an understanding of their perspectives.

To get a proper understanding of risk within a business, a company will usually require a cross discussion by directors' with different organizational functions. For example, an understanding of human rights issues will require an understanding of the sectors and locations company's supply chain, and therefore information from procurement personnel.

The FRC does not need to recreate the wheel in this area, but does need to help signpost more detailed guidance, otherwise companies are unlikely to comply. There are a number of reporting standards that help companies disclose non-financial information (e.g. GRI, IIRC, ISO 26000, UN Guiding Principles on Human Rights). These should be signposted as information sources (as has been done in the Defra guidance on GHG reporting and the EU non-financial information directive guidance), to help companies.

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?

I think there should be two more communication principles: transparency and comparability.

Companies are making decisions about what they consider their investors or other stakeholders assess as being material. There should be transparency about how this process was undertaken, as described above. There should also be transparency on the risks, ensuring that all the significant risks are covered and disclosed. The principle of transparency is fundamental in non-financial reporting standards such as Integrated Reporting and the Global Reporting Initiative.

There also needs to be transparency on the level of assurance undertaken by the company, of its reporting processes. The legislation only requires a consistency analysis between the information in the strategic report and the accounts, it does not cover how the disclosures in the strategic report were made. Therefore, a principle of transparency can help ensure companies focus on the process, rather than solely on the disclosures.

Comparability should be added as a principle. This is particularly important for the Key Performance Indicators. Eurosif and ACCA conducted a survey of European investors and financial or non-financial analysts. The survey was conducted from November 2012 to April 2013 and with 93% of respondents disagreeing or strongly disagreeing that current non-financial reporting is sufficiently comparable. There are sector-wide indicators recommended by Defra, the GRI, and UNEPFI.

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 statement should be made clearer to capture the point that improvements to the structure of the strategic report should include only quality information, in line with the aim of decluttering the strategic report

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?
No, in the content elements in 6.64, this should be made clear that it is a 'comply or explain' requirement.

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?

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?

It does

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?

Yes