

Guidance on the Strategic Report

Exposure Draft issued in August 2013 by the Financial Reporting Council (FRC)

Comments from ACCA

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Further information about ACCA's comments on the matters discussed here may be obtained from the following:

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ACCA welcomes the opportunity to comment on the above Exposure Draft (ED). UK and Ireland-based members of our Global Forum for Corporate Reporting have considered the proposals, and their views are reflected in the following general and specific comments.

GENERAL COMMENTS

ACCA supports the idea of practical guidance, to assist the preparers of financial statements in 'telling the story' of their company through the Strategic Report (SR). We note that the Department for Business, Innovation and Skills is encouraging companies to be experimental, if this results in a full and informative presentation. ACCA also supports guidance on the SR which has regard to the content of the Annual Report (AR) as a whole, and which also attempts to clarify what preparers should regard as material or otherwise 'significant'.

As set out in our specific comments below, we agree with some of the content of the ED, but also have some concerns that it may not give sufficient encouragement, overall, to preparers to present the SR both compliantly, and at the same time, in their own way. The ED provides an opportunity for a 'step change' in narrative reporting and in our view, more could have been made of this. In this regard, we have pointed out below in our specific responses, areas which either need clarification, or where less detail would be helpful.

It would be helpful for the above overall objective to be clearly stated, either in the section on Communication Principles (as mentioned in the response to Question 5 below), or in a separate brief Foreword.

In addition, ACCA has a concern that the guidance has been written with quoted companies in mind (para 2.1), as reflected in its content, and the inclusion of cross-references to the Corporate Governance Code. We question the resulting lack of emphasis on the majority of preparers of the SR, which will be unquoted companies.

Unquoted companies, especially medium-sized ones, have fewer reporting requirements and more straightforward business models compared to those which

are quoted. Furthermore, they are more likely to need guidance than large well-resourced quoted entities, whilst at the same time there is a need for them to be able to see the benefit of guidance which is non-mandatory. In our view, it would have been preferable for the FRC to follow the approach now adopted by Government, which is to consider first the smaller companies affected, then add on material relevant to the larger companies, including those which are quoted.

The SR is a requirement of company law, and specifically, arises from directors' legal duties. This is acknowledged in para 6.4, which usefully sets out the requirements of s. 172 Companies Act 2006 concerning the directors' duty to promote the success of the company. However, we see a particular weakness in the ED, insofar as Section 6 does not then go on give guidance specifically on these statutory requirements.

By the same token, we believe that para 3.4 should refer to directors rather than 'management'. This change would acknowledge the accountability in law of directors to shareholders, both in running a company, and reporting on it. We have also questioned below the role of the Directors' Report (DR) envisaged by the ED, as we do not regard this as being principally a 'compliance' document of lesser interest to users of the Annual Report.

ACCA acknowledges that guidance on materiality cannot be comprehensive, due to the inevitable need for judgement in the application of the concept. Similarly, the main impetus for innovation comes from within the reporting entity, and so guidance on the SR cannot achieve the desired result without a willingness by companies to adopt it in the appropriate manner.

We support the provision of linkage examples, in the interest of clarity and conciseness in the AR, but have pointed out instances where the examples do not appear to have enough relevance to the sections of the ED to which they are related. In this regard, we would support the inclusion of examples which are more specific and detailed. Companies which have the right approach to following the guidance would not simply adopt these as templates for their SR.

Finally, we note that there are a number of common areas with the proposed framework for Integrated Reporting. Whilst the ED is a specific response to the statutory requirements for the SR, we believe that it would be advisable for the

FRC to have regard to the IIRC's latest proposals. This may avoid duplication and confusion in the future.

SPECIFIC COMMENTS

We now comment on the specific questions raised in the ED, as follows:

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.

Question 1

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

ACCA response

We support the FRC's approach of distinguishing the different parts of the AR, whilst ensuring cohesiveness between the SR and the other parts (Section 1, para 1.1(c)). However, the usefulness of the content of Illustration 1 appears limited. The detail given often states what will already be known about the purpose and content of the components of the AR, both by preparers, and shareholders with a reasonable knowledge of Company Law and corporate reporting. Higher-level objectives, focussing on the distinctions between the main focus of each section (e.g. forward-looking, compliance) might well provide greater clarity.

The first section objective relating to the SR could usefully be more specific than aiming to 'provide context for the related financial statements', as the objective relates directly to the important theme of cohesiveness above.

Question 2

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

ACCA response

The very general objective stated for the DR ('to provide other statutory information about the entity') appears to highlight the FRC's view that the SR is the place for the company to 'tell its story' in an informative way, with the DR containing residual (mainly, compliance) information. If this is the FRC's view, it would be helpful if it were clearly stated.

Illustration 1 is an example of how the guidance gives the appearance of having been written primarily with quoted companies in mind. As the guidance will not be mandatory, it needs to be stratified so that unquoted (and especially medium-sized) companies are readily aware of the sections of particular relevance to them. In general, the smaller the company encompassed by the guidance, the more likely it will be in need of guidance.

The objectives also need clarification in one particular respect. Future prospects are included in the SR objective, but they are only required in the SRs of quoted companies. The DR has, by law, to indicate future developments for all companies except those which qualify as small. It is legally permissible to cover, in the SR, information required in the DR, and it would be helpful if the FRC would state which information it believes should be treated in this way. If this includes future developments, it would then be clear that the guidance envisages that all non-small companies will include it in their SR.

Whilst each section and component will have its own specific objectives, it would assist the desired cohesiveness within the Annual Report if common objectives were given across components. This would also accord with the aim of the ED to provide linkages between the various parts of the Annual Report.

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?

ACCA response

ACCA agrees that overall, this section of the guidance is likely to have a positive effect, in a practical sense. For example, the point on avoiding duplication (para 3.14) accords with the FRC's aim of improving reporting in the AR as a whole. There is also a suggestion (para 3.12, third example) that certain detailed required disclosures, required for particular accounting areas, but unchanged year-to-year, could be included in a 'standing information' appendix to the AR.

The guidance in paras. 3.10 to 3.14 is consistent with previous work by the FRC, but needs to be broadened in order to achieve the innovative 'step change' referred to in our General Comments above. This might be done by analysing the overall themes for each section of the AR (such as 'forward-looking', 'compliance').

The suggestion (first example) of relegating the DR to an appendix at the end of the AR, is consistent with a view that the DR should be focussed primarily on compliance information of lesser interest to shareholders. However, it can be argued that the Companies Act 2006 does not envisage a subsidiary role for the DR, and that certain messages within the DR, such as on the disclosure of information to the external auditor, merit prominence each year.

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?

ACCA response

The definition of materiality does, in our view, reflect the generally accepted understanding of this concept, including by the IASB. ACCA agrees that the FRC needs to follow the generally-accepted meaning of the term, and the ED also includes useful attempts to explain the terms 'key' and 'principal' (para. 5.4). We have referred above to the proposed Integrated Reporting framework, and the FRC may wish to consider how the proposed framework's concept of materiality will be consistent with the guidance in this ED.

As defined in the Glossary to the ED, materiality in the context of the SR differs from the IASB's definition (Conceptual Framework, para. QC11) by referring to influence on shareholders, rather than a broader range of users. This appears to reflect the legal status of the SR, and the ED does furthermore, acknowledge the wider constituency of users in para 3.6.

We view the guidance on immaterial information as both practical, and in accordance with wider current thinking on disclosure. The inclusion of a specific statement about the adverse impact of including immaterial information (para 5.1 and Glossary) will be welcomed by supporters of a reduction in 'clutter' in Annual Reports. The statement is further supported by the encouragement of proportionate disclosure (paras. 5.2 and 5.5).

In the first sub-paragraph of para. 5.1, we suggest that the second sentence is made more specific by reading: 'Material should be included in the strategic report if it meets this test'.

Notwithstanding the FRC's definition and guidance, materiality and immateriality will always entail a degree of application judgement, and consequently, complete guidance cannot be provided. We believe that it would be helpful for the ED to make this clear, and that the FRC has provided as much guidance as is possible.

Finally, we would appreciate clarification in the ED on one specific matter. Para 5.4 defines 'key' and 'principal' in terms of importance to shareholders. 'Important' is not defined, and para 6.66 refers to information which is 'important but not material'. It would be helpful if the ED confirms that 'material' is more weighty as a concept than 'important' (and hence 'key and principal').

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?

ACCA response

Paras. 6.5-6.27 of the ED encourage understandability and accuracy, which will generally be accepted as important overall qualities for the SR. The encouragement of a proportionate approach to the level of information provided is in accordance with the guidance given on materiality and immateriality in the ED (as discussed above).

As the above principles are high-level, generally acceptable, and incorporated in guidance which is not prescriptive, coverage of them in the ED should not need to be lengthy. The amount of coverage reflected by sub-paragraphs 6.5 – 6.27 is consequently likely to be too much, maybe even detracting from the important theme of companies deciding for themselves how to 'tell their story'. As set out in our General Comments above, we would prefer less detail and a clear statement of the main overall objective of narrative reporting.

In the context of companies making their own decisions, ACCA does welcome, in addition, the encouragement for directors to perform a critical annual review to maintain the relevance.

With regard to specific parts of this section, we believe that this section of the guidance should highlight requirements which are applicable to quoted companies (such as in para 6.6), and should be consistent in how it relates to the Companies Act 2006. For example, 'comprehensive' (para 6.15) is a term in the Act, but is not given bold-type status. Its opposing concept 'concise' (para 6.11) is not a term in the Act, but has bold-type status.

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?

ACCA response

As set out in our response to Question 5 above, ACCA supports a critical annual review of the SR by the Directors' use of judgement (as in 5. above). We agree, however, that changes in the SR should not, as far as possible, detract from comparability between periods for the sake of reflecting present circumstances.

It would be helpful for the FRC to make the above point through an addition to para 6.27. One possible way of maintaining comparability might well be by additional explanations in the year of change, where it is helpful to do so.

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?

ACCA response

The FRC has been asked to provide non-mandatory guidance relating to the legal requirements for a SR. Consequently, ACCA agrees that it is appropriate for the 'content elements' to reflect the legislative requirements, without going beyond them.

Guidance on other matters would be seen as outside the scope of the legislation, and the work requested of the FRC. It might therefore be less likely to gain acceptance as 'best practice', unless it is subject to a separate consultation exercise, the costs and benefits of which would need to be assessed.

Para 6.6g gives the definition of a senior manager, as set out in the Companies Act 2006. This appears to be almost identical to the definition of 'key management personnel' given in FRS 102, insofar as the latter term applies to non-directors. If the ED were to include a confirmation that the two terms can be considered identical, this would assist preparers of the SR and statutory financial statements. It would also assist users of the AR, when comparing the content of the SR with the disclosures in the financial statements.

In view of the amount of material in the 'content elements' section, we would draw attention to our concern (expressed in the response to Question 5 above) that the more detailed and specific any part of the guidance is, the greater the risk that companies will not be encouraged to think freely about the content of the SR.

Equally, other reporting themes which have arisen could be concisely covered by attaching them to the principal content elements. For example, capital management could be attached to the section on strategy (para 6.31 onwards) and judgement in setting accounting policies to the section on managing risks (para 6.49 onwards).

Our previous comments about relevance to the needs of unquoted companies, particularly medium-sized entities, also apply to the guidance on the 'content elements'.

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?

ACCA response

With regard to quoted companies, ACCA concurs that sufficient guidance is provided on the business model. Paras 6.38-6.41 appropriately set out what the description should cover, firstly in overall terms, then in the important specific area of market information.

We believe that there is a limit to how specific guidance on the business model could then go on to be, as ultimately, it is for the directors of an entity to decide how to explain this in the way which they believe is the most appropriate.

The guidance is less applicable to the more straightforward unquoted companies, particularly medium-sized ones. These companies would benefit from appropriate guidance which reflects for example, their more straightforward business model, and their tendency to be more guarded in disclosing information, compared to quoted companies. If the unquoted companies do not feel that a part of this non-mandatory guidance is relevant to them, they may choose to ignore it if there is no need to do otherwise (such as to meet the expectations of finance providers).

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?

ACCA response

The 'content elements' section of the ED does indicate that there is sufficient differentiation of these three concepts, which are furthermore, separately defined in the Glossary. As a result, the guidance is consistent with the legislation which covers the concepts in separate sub-sub-sections.

Furthermore, whilst an entity's business model, objectives and strategies do impact on each other, we believe that it would not assist clarity in the SR if there was a large degree of overlap in the guidance relating to them.

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?

ACCA response

ACCA supports the principle of including linkage examples in the guidance. Illustrations of how information is connected throughout the AR should help to

reduce duplication by preparers, and should encourage critical thought by directors of how the AR is structured overall.

Overall, we would prefer examples which are more specific to the section of the ED in which they are included, and contain sufficient detail to indicate how a company could 'tell its story' in that particular area.

We have the following points to make on specific examples which we believe could be made more relevant to the sections of the ED which they illustrate:

- Para 6.36: the linkage example does not specifically cover key performance indicators, which is the topic covered by this paragraph.
- Para 6.48 (trends and factors): the linkage example refers to the resulting risks and opportunities, and the strategies adopted, but might more usefully refer to appropriate information in the financial statements.
- Para 6.56 (KPIs): the second linkage example could be clearer about how executive pay is affected by company performance (as reflected by the KPIs), which in turn is partly dependent on the impact of the stated principal risks affecting the entity.
- Para 6.65: it is not clear how the factors mentioned in the second linkage example (such as key inputs and outputs) relate to the subject of this section of the ED (environmental matters, employees and social / human rights issues).