Financial Reporting Council

August 2013

Exposure Draft: Guidance on the Strategic Report

The FRC is responsible for promoting high quality corporate governance and reporting to foster investment. We set the UK Corporate Governance and Stewardship Codes as well as UK standards for accounting, auditing and actuarial work. We represent UK interests in international standard-setting. We also monitor and take action to promote the quality of corporate reporting and auditing. We operate independent disciplinary arrangements for accountants and actuaries; and oversee the regulatory activities of the accountancy and actuarial professional bodies.

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Contents

Introduction

(i) The Financial Reporting Council's (FRC) aim is to promote high quality corporate governance and reporting to foster investment. The FRC believes that encouraging entities to prepare a high quality strategic report – which provides shareholders with a holistic and meaningful picture of an entity's business model, strategy, development, performance, position and future prospects – is a key part of achieving this aim.

(ii) The existing guidance on the business review (the part of the directors' report that the strategic report will replace) is in the form of the Accounting Standards Board's *Reporting Statement: Operating and Financial Review* (RS). The RS was published as a statement of best practice in January 2006 following the repeal of the statutory Operating and Financial Review (OFR) regulations, which were introduced in 2005.

(iii) In May 2010, as part of the Coalition Agreement, the UK Government announced its intention to 'reinstate an Operating and Financial Review to ensure that directors' social and environmental duties have to be covered in company reporting, and investigate further ways of improving corporate accountability and transparency[1]'.

(iv) New Regulations[2], which amend existing company law requirements and follow a series of Government consultations on the Coalition Agreement plans, become effective on 1 October 2013. The main change introduced by the Regulations is a requirement for certain companies to prepare a strategic report as part of their annual report. The new requirements will apply for periods ending on or after 30 September 2013.

(v) The Department for Business, Innovation and Skills (BIS) has asked the FRC to prepare non-mandatory guidance supporting the strategic report requirements in the new Regulations. While the changes introduced by the Regulations represent a relatively modest change to the pre-existing legal requirements, the FRC believes that they should act as a catalyst for entities to prepare more concise and relevant narrative reports. The new guidance is, therefore, intended to encourage preparers to consider how the strategic report fits within the annual report as a whole and help enhance the quality of narrative reporting more generally.

(vi) When developing the proposed guidance, the FRC was mindful of developments in Integrated Reporting. In common with the International Integrated Reporting Council (IIRC), the FRC seeks to improve the quality of corporate reporting and, in consequence, has met and shared ideas with the IIRC throughout the development of this guidance. In contrast to an integrated report, the strategic report is required as part of the annual report in the UK, with its purpose and content largely determined by legislation. This fact notwithstanding, the proposed International Integrated Reporting Framework and the proposed guidance in this Exposure Draft encourage similar qualitative characteristics and content.

(vii) The FRC has developed guidance that aims to be:

(a) principles-based;

(b) shorter and more streamlined than the RS;

(c) mindful of recent developments in narrative reporting best practice; and

(d) aligned with the requirements in the *UK Corporate Governance Code*.

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1 'The Coalition: our programme for government (May 2010)' – https://www.gov.uk/government/publications/the-coalition-our-programme-for-government

2 The Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013 (the 'Regulations')

Invitation to comment

1. The FRC is requesting comments by 15 November 2013. The FRC is committed to developing guidance and standards based on evidence from consultation with users, preparers and others. Comments are invited on all aspects of the proposals. In particular, comments are sought on the questions below.

2. Comments are most helpful if they indicate 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 judgements regarding where information would be best presented.

Question 1

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

Question 2

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

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?

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?

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?

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?

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?

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?

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?

[Draft] Guidance on the Strategic Report

Summary

(i) The [draft] *Guidance on the Strategic Report* serves as a best practice statement and, as such, has persuasive rather than mandatory force. One of its objectives is to set out high-level principles that enable entities to 'tell their story'.

(ii) The [draft] guidance is for directors and has been written with quoted companies in mind. However, it may also be useful for other entities[3] preparing strategic reports.

(iii) The [draft] guidance aims to encourage information in annual reports to be more relevant to shareholders. With that in mind, the [draft] guidance is framed in the context of the annual report as a whole. In practice, an annual report comprises three distinct components – narrative reports; corporate governance statements; and financial statements. The information contained in these components has different objectives which should guide preparers to where disclosures could be located. The aim is to promote cohesiveness and enable related information to be linked together.

(iv) Placement is a key theme in the [draft] guidance with a view to providing entities with the building blocks to experiment with where information is located. A 'core and supplementary' approach to organising information in the annual report is suggested whereby important information for shareholders is given prominence with supplementary information presented elsewhere.

(v) The overriding objective of narrative reporting is to 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.

(vi) The strategic report is an integral part of narrative reporting and is the focal point of the [draft] guidance. The [draft] guidance includes sections on the application of materiality to the strategic report, communication principles, and content elements.

(vii) The guidance recommends that only information that is material to shareholders should be included in the strategic report. Immaterial information should be excluded as it can obscure the key messages and impair understandability.

(viii) The communication principles suggest that strategic reports should have the following characteristics – be fair, balanced and understandable; be concise; have forward-looking orientation; include entity-specific information; and link-related information in different parts of the annual report. They are intended to emphasise that the strategic report is a medium of communication between a company's directors and its shareholders.

(ix) The content elements for the strategic report set out in the [draft] guidance are derived from the Companies Act 2006, as amended by the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013, and include a description of the entity's objectives, strategies and business model. In addition, the strategic report should include an explanation of the main trends and factors affecting the entity; a description of its principal risks and uncertainties; an analysis using key performance indicators; and an analysis of the development and performance of the business. Disclosures around the environment, employees, social issues, and diversity are also incorporated.

[3] This [draft] guidance uses the broader term 'entity' unless the term 'company' is more appropriate in a specific context.

Section 1
Objectives and how to use this guidance

1.1 The objectives of this [draft] *Guidance on the Strategic Report* are to:

(a) ensure that relevant information that meets the needs of shareholders is presented in the **strategic report**;

(b) encourage companies to experiment and be innovative in the drafting of their **annual reports**, presenting narrative information in a way that enables them to best 'tell their story' while remaining within the regulatory framework; and

(c) promote greater cohesiveness in the annual report through improved linkage between information within the strategic report and in the rest of the annual report.

1.2 This non-mandatory guidance is structured as follows:

1.3 **Boxed text in bold type describes the main principles or, in paragraphs 6.28 to 6.73, content elements that form the basis of this [draft] guidance. Where the main principle or content element is derived from legislative or other regulatory requirements, those requirements are referenced in the footnotes to this guidance.**

1.4 The bold text is followed by further supporting guidance explaining how the main principles and content elements might be applied. The supporting guidance is then supplemented by highlighted text as follows:

Summary of legal requirements

Where the law or regulation underpinning the [draft] guidance requires explanation or highlighting, this information is included in a 'summary of legal requirements'. This information is intended to summarise important aspects of the legal requirements; it is not intended to be a comprehensive analysis of the law.

Example

Where a specific paragraph warrants further application guidance, practical examples are included. These examples are intended to be illustrative only and may not be appropriate for all entities.

Linkage example

One of the main aims of this [draft] guidance is to encourage the preparation of more cohesive annual reports. The 'linkage examples' illustrate ways in which interdependencies or relationships between strategic report content elements might be highlighted or presented. The linkage examples are not intended to be a comprehensive list of all possible linkages in the strategic report, nor are they intended to be a template for the presentation of information.

1.5 Terms defined in the Glossary (Appendix I) are in **bold type** the first time they appear in each section.

Section 2
Scope

2.1 **This [draft] guidance has been written with quoted companies in mind. It may also serve as best practice guidance for other entities[4] preparing strategic reports.**

Summary of legal requirements

Section 414A of **the Act** requires all companies that are not small to prepare a **strategic report** which contains a fair and balanced review, consistent with the size and complexity of the business, of:

(a) the development and performance of the company's business during the financial year;

(b) the position of the company at the end of the year; and

(c) a description of the **principal risks** and uncertainties facing the company.

Large companies should include both financial and non-financial **key performance indicators** (KPIs) in their review whereas medium-sized companies are exempt from the requirement to include non-financial KPIs. The strategic report of a **quoted company** is required to include additional information, including a description of its **strategy** and **business model**. A detailed analysis of the Act's requirements in respect of the strategic report is set out in Appendix II.

Section 415 of the Act requires all companies to also prepare a **directors' report** which contains other information specified by the Act and its associated regulations[5]. A detailed analysis of the Act's and its associated regulations' requirements in respect of the directors' report is set out in Appendix III.

Both the strategic report and the directors' report are integral parts of the **annual report**.

4 This [draft] guidance uses the broader term 'entity' unless the term 'company' is more appropriate in a specific context.

5 In the case of a medium-sized or large company, the 'Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008'. In the case of small companies, the 'Small Companies and Groups (Accounts and Directors' Reports) Regulations 2008'.

Section 3
The annual report

The purpose of the annual report

3.1 Although this [draft] guidance is primarily focused on the application of the **strategic report** requirements, it also addresses the role of that report in the context of the **annual report** as a whole. This recognises that the strategic report does not exist in isolation.

3.2 In practice, an annual report often comprises three distinct ‘components’: the narrative reports (the strategic report and the **directors’ report**), corporate governance statements and the financial statements. Each of these components seeks to achieve different but linked objectives. Related to these components, company law and/or other regulations require certain ‘sections’ to be included within the annual report.

3.3 Illustration 1 sets out an overview of the possible components and sections of a **quoted company’s** annual report, their different objectives, and the principal sources of the related disclosure requirements. The illustration is intended to help preparers make judgements regarding where information would be best located in the annual report. It is not intended to:

(a) impose or imply a specific structure on an annual report. As discussed more fully in paragraph 3.11, the annual report is a medium of communication between the company’s directors and its shareholders. The structure of the annual report should facilitate that communication while also complying with company law and other regulatory requirements.

(b) be comprehensive and restrict the directors only to the sections it specifically names. The illustration describes only the sections required by company law or other regulations; other sections not included in the overview (eg a Chairman’s Statement) can still be included in the annual report if, in the directors’ opinion, that is the best way of helping to ensure that the document as a whole is fair, balanced and understandable.

Illustration 1

Document	Annual Report				
Document purpose	• The purpose of the annual report is to provide shareholders with relevant information that is useful for making resource allocation decisions and assessing management's stewardship				
Component	**Narrative Reports**		**Corporate Governance Statements**		**Financial Statements**
Component objectives	• To provide information on the entity and insight into its main objectives and strategies, and the principal risks it faces • To complement, supplement and provide context for the related financial statements		• To provide information that enables the assessment of whether the entity has the right governance to execute its strategies and evaluate whether executive remuneration plans effectively incentivise delivery of those strategies		• To present the entity's financial position, performance and development in accordance with Generally Accepted Accounting Practice on a comparable basis
Section	**Strategic Report**	**Directors' Report**	**Corporate Governance Report**	**Directors' Remuneration Report**[6]	**Financial Statements**
Section objectives	• To provide context for the related financial statements • To provide an analysis of the entity's past performance • To provide insight into the entity's main objectives and strategies, and the principal risks it faces and how they might affect future prospects • To provide signposting to show the location of supporting detail	• To provide other statutory information about the entity	• To provide information necessary to explain how the composition and organisation of the entity's governance structures supports the achievement of the entity's objectives	• To set out all elements of the entity's executive remuneration policy and key factors that were taken into account in setting the policy • To report on how the executive remuneration policy has been implemented • To set out amounts awarded to directors and provide details on the link between the entity's performance and executive remuneration	• As above
Main sources of annual report disclosure requirements for a UK company with a primary listing on the London Stock Exchange	• **The Act** s414C • **The Code** C.1.2 • **DTR** 4.1[7]	• SI 2008/410[8] Sch 7 • DTR 4.1	• The Code • **LR** 9.8.6(5)–(6) • DTR 7.1[9] • DTR 7.2	• SI 2008/410 Sch 8 • LR 9.8.8	• Accounting standards • The Act • SI 2008/410
	• LR 9.8 requires the inclusion of certain specific disclosures in the 'annual financial report'				

6 Separate guidance on the disclosures to be included in the Directors' Remuneration Report will be published by the GC100 Investor Working Group
7 DTR 4.1 refers only to a 'management report'
8 SI 2008/410 = The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008
9 LR 9.8.6(5)-(6) requires all of this information to be in the annual report

3.4 **The purpose of the annual report is to provide shareholders with relevant information that is useful for making resource allocation decisions and assessing management's stewardship.**

3.5 The annual report should provide the information necessary for shareholders to assess the entity's:

(a) development, performance and position;

(b) future prospects;

(c) **strategy** for achieving its **objectives**;

(d) **business model**; and

(e) governance**.**

3.6 Although shareholders' needs are paramount, when directors consider what information should be included in the annual report, the needs of other investors (such as debt investors) and potential investors, and their advisers, should also be given a high priority.

3.7 Information in the annual report will also be of interest to users other than investors. For example, creditors, customers, suppliers, employees and members of society more widely may wish to use information contained within it. The annual report should address issues relevant to those other users where, because of the influence of those issues on the development, performance, position or future prospects of the entity's business, they are also of significance to shareholders. The annual report should not, however, be seen as a replacement for other forms of reporting addressed to other stakeholders.

3.8 **The annual report as a whole should be fair, balanced and understandable.**

3.9 Provision C.1.1 of **the Code** requires the 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.

Placement of information in the annual report

3.10	**The placement of information in the annual report should facilitate the communication of the information contained in it.**

3.11 The annual report is a medium of communication between the company's directors and its shareholders. Its structure should facilitate that communication while also complying with company law and other regulatory requirements. Effective communication of the matters required to be addressed in an annual report will not usually be achieved through the use of a 'checklist style' approach to drafting, which can result in its structure being driven by the order in which disclosure requirements arise and the presentation of more granular detail in such a way that other important information is obscured.

3.12 A 'core and supplementary information' approach will often achieve improved flow and cohesiveness in the annual report and result in a more relevant and understandable document. This approach is intended to ensure that the most important information is given prominence in the annual report. Other detailed information could be presented in appendices to the annual report or, where company law or other regulation allows it, in a separate document or online.

Example

Directors should consider the most appropriate ordering of the different sections within the annual report. For instance, it may be appropriate to locate some detailed regulatory information in the directors' report and to position the directors' report as an appendix in the annual report.

Example

Directors should consider the most appropriate location for more detailed information. For example, the strategic report should focus on business segments that are material to the group as a whole. More granular information could be included either in an appendix to the annual report or, to the extent that it is not required to meet company law or other regulatory requirements, outside of the annual report altogether. Cross-references from the strategic report could be used to signpost this more detailed information.

Example

Some accounting standards require the disclosure of large amounts of explanatory detail which, while material to an understanding of particular items in the financial statements, may not change from year to year. The directors might consider locating these disclosures in a separate (audited) 'financial information' appendix to the annual report.

3.13 Directors will usually place their strategic report, which contains their views on core items, in a prominent position in the annual report and show linkages to other information placed elsewhere.

3.14 Duplication of information should be avoided as it usually leads to unnecessary volumes of disclosure and detracts from the understandability and usefulness of the annual report as a whole.

Summary of legal requirements

Section 463 of **the Act** provides that directors are liable to compensate their company if the company suffers any loss as the result of any untrue or misleading statement in (or any omission from) the directors' report, the directors' remuneration report or the strategic report. However, directors will only be liable in these circumstances if they knew that the statements concerned were untrue or misleading or if they knew that the omission concerned was a dishonest concealment of a material fact: this protection is sometimes known as 'safe harbour'. In order to benefit from this protection information should be included within one of these reports. Whether information is included directly or incorporated by reference is a matter for preparers and their advisers.

Section 4
The narrative reports

4.1 The **narrative reports** comprise the **strategic report** and the **directors' report**. The objectives of the narrative reports are:

- to provide information on the entity and insight into its main **objectives** and strategies, and the **principal risks** it faces; and
- to complement, supplement and provide context for the related financial statements.

4.2 Information in the narrative reports should complement as well as supplement the financial statements.

4.3 In complementing the financial statements, the narrative reports should provide information about the business and its development, performance or position that is not reported in the financial statements but which might be relevant to the shareholders' evaluation of past results and assessment of future prospects.

4.4 In supplementing the financial statements, the narrative reports should provide additional explanations of amounts recognised in the financial statements and explain the conditions and events that shaped the information contained in the financial statements.

Section 5
Strategic reports and materiality

5.1 **Information is material if its omission from or misrepresentation in the strategic report might reasonably be expected to influence the economic decisions shareholders make on the basis of the annual report as a whole. Such information should be included in the strategic report.**

Conversely, the inclusion of immaterial information can obscure key messages and impair the understandability of information provided in the strategic report. Immaterial information should be excluded from the strategic report.

5.2 The **strategic report** should contain only the information that is relevant to shareholders' needs. The inclusion of too much information or detail may obscure matters of importance and will not promote a clear understanding of the entity's development, performance, position and future prospects.

5.3 Where information is required '...to the extent necessary for an understanding of...' (for example, in the disclosure of trends or factors described in paragraph 6.42), it should be included in the strategic report when, and only when, it is material to shareholders.

5.4 The terms 'key' (eg as used in the term '**key performance indicators**') and 'principal' (eg as used in the term '**principal risks** and uncertainties') refer to items or circumstances that are (or should be) considered important for a shareholder's understanding of the development, performance, position or future prospects of the business. For example, these could be the performance indicators considered by the board and used in management reporting.

5.5 The number of items disclosed as a result of these requirements will generally be relatively small; they should not, for example, result in a comprehensive list of all performance measures used within the business or of all risks and uncertainties affecting the entity.

5.6 The strategic report should focus on those matters that are material to an understanding of the development, performance, position or future prospects of the entity when taken as a whole. In the annual report of a parent company, for example, the strategic report should include only those matters that are material to the company and the subsidiary undertakings included in the consolidation when taken as a whole. Such matters may be specific to a single business segment or be of a wider relevance.

5.7 The concept of materiality cannot be applied to disclosures which are required by company law or its associated regulations unless explicitly allowed (for example, through the use of the term '...to the extent necessary for an understanding of...' or 'principal').

Summary of legal requirements

Section 414C(14) of **the Act** clarifies that the disclosure of confidential information about impending developments or matters in the course of negotiation is not necessary if the disclosure would, in the opinion of the directors, be seriously prejudicial to the interests of the company. This is the case even if that information is considered material.

Section 6
The strategic report

The purpose of the strategic report

6.1 **The strategic report should provide shareholders of the company with the ability to assess how the directors have performed their duty to promote the success of the company for their collective benefit.**

6.2 The strategic report has three main content-related objectives:

(a) to provide context for the related financial statements;

(b) to provide shareholders with an analysis of the entity's past performance; and

(c) to provide insight into the entity's main objectives and strategies, and the principal risks it faces and how they might affect future prospects.

6.3 The strategic report should also provide signposting to show the location of supporting detail.

6.4 The strategic report should reflect the collective view of the company's directors.

Summary of legal requirements

The purpose of the **strategic report** 'is to inform members of the company and help them assess how the directors have performed their duty under s172' of **the Act**[10].

The duty of a director, as set out in s172 of the Act, is to 'act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to:

(a) the likely consequences of any decision in the long term;

(b) the interests of the company's employees;

(c) the need to foster the company's business relationships with suppliers, customers and others;

(d) the impact of the company's operations on the community and the environment;

(e) the desirability of the company maintaining a reputation for high standards of business conduct; and

(f) the need to act fairly as between members of the company'.

Section 426 of the Act allows a company, in certain circumstances, to send its members the strategic report with supplementary material instead of the **annual report**. The supplementary material includes information on the audit report issued on annual accounts and, in the case of a **quoted company**, limited extracts from the directors' remuneration report. This option replaces the option to send summary financial statements.

[10] Section 414C(1) of the Act

The communication principles

6.5 The communication principles provide guidance on the qualitative characteristics of the disclosures included in the strategic report. They are also relevant in the drafting of the annual report as a whole.

6.6 **The strategic report should be fair[11], balanced[12] and understandable[13].**

6.7 The strategic report should be neutral, addressing positive and negative aspects of the entity's development, performance, position and future prospects. The directors should ensure that shareholders are not misled as a result of the omission of, or emphasis given to, any information on any aspects of the entity's development, performance, position or future prospects.

6.8 The strategic report should be written in plain language. The excessive use of jargon and industry specific terms should be avoided where possible. Where the use of such terms is necessary, they should be clearly defined and used consistently.

6.9 The method of presentation can significantly affect the understandability of information in the strategic report. The most appropriate method of presentation will depend on the nature of the information but may include tabular, graphical or pictorial methods as well as text. A combination of these methods may also sometimes be appropriate.

6.10 The directors should also take into consideration the strategic report when ensuring that the annual report, when taken as a whole, is fair, balanced and understandable.

6.11 **The strategic report should be concise.**

6.12 The strategic report should contain only the strategic and other important information that is relevant to the assessment of how the directors have performed their duty to promote the success of the company for the benefit of its shareholders.

Example

Information regarding the settlement of a material legal claim against an entity may not be considered 'strategically significant' information. It is, however, important contextual information relating to the period under review which should be included in the strategic report.

6.13 The application of materiality contributes to concise reporting. Guidance on **materiality** as applied to the strategic report is located in Section 5.

6.14 The appropriate placement of information within the annual report also contributes to concise reporting. Guidance on the placement of information is provided in paragraphs 3.10 to 3.14.

[11] Section 414C(2)(a) of the Act
[12] Section 414C(3) of the Act
[13] **The Code**, Provision C.1.1

6.15 The strategic report should also be comprehensive[14]. This does not mean that it should cover all possible matters in substantial detail; the strategic report should include only focused information, which is important to the entity when taken as a whole and is relevant to shareholders' needs.

6.16 **Where appropriate, information in the strategic report should have a forward-looking orientation.**

6.17 Information on how a fact or circumstance might affect the entity's future development, performance or position should be included in the strategic report. This information is not the same as a forecast of future results, instead it is a focus on aspects of the year under review that are relevant to an assessment of future prospects.

6.18 The strategic report should not concentrate solely on a single timeframe. Where relevant to an understanding of the development, performance, position or future prospects of the entity, the strategic report should give due regard to the short-, medium- or long-term implications of the fact or circumstance being described.

6.19 **The strategic report should provide information that is entity-specific.**

6.20 The inclusion of generic or 'boilerplate' information on its own is of only limited use to shareholders. However, information on how a particular fact or circumstance might affect, or has affected, the development, performance or position of the entity's business and how it is responding to the fact or circumstance provides more insightful information that can be used in the assessment of the entity's future prospects.

6.21 **The strategic report should highlight relationships and interdependencies (linkages) between information presented in different parts of the annual report.**

6.22 There are many examples where the disclosure of similar or related information results from the application of different sources of requirements that apply to different parts of the annual report. While each part of the annual report is independently useful, more valuable insight can be provided if linkages between the information in different components and sections are highlighted.

Linkage example

Separate sections detailing an entity's business strategy and directors' remuneration arrangements may be informative. However, highlighting linkages between these two elements of the annual report might provide a deeper insight into the entity's executive incentivisation policies.

6.23 The most appropriate method of dealing with these similar or related requirements will depend on factors such as the nature of the information and any regulatory requirements specific to the disclosures being made.

[14] Section 414C(3) of the Act

6.24 The use of cross-references is one method for linking related information. Clear signposting between the strategic report and other narrative reports, the corporate governance statements, the financial statements or, where regulation allows, other material outside of the annual report will enable the reader to readily ‘drill down’ into greater levels of detail, should they wish to do so.

Linkage example

An entity might identify the funding of a large defined benefit pension scheme deficit as a principal risk and include a high-level description of the funding risk in the strategic report. This description could cross-reference to the defined benefit pension scheme disclosures, in the notes to the financial statements, enabling shareholders to drill down to greater levels of detail on that subject should they so wish.

6.25 Combining disclosures made under requirements from different sources may enable linkages to be demonstrated clearly in one place.

Linkage example

A manufacturing entity might have an objective to reduce its greenhouse gas (GHG) emissions. The directors may conclude that the most efficient and informative approach is to combine, and present in the strategic report, the disclosures that meet the strategic report requirement to describe the entity’s strategy for the reduction of its GHG emissions with the disclosure of GHG emissions data required in the directors’ report.

6.26 **The structure and presentation of the strategic report should be reviewed annually to ensure that it continues to meet its objectives in an efficient and effective manner.**

6.27 When contemplating a change to the structure or presentation of the strategic report, directors should consider whether the change represents an improvement in the quality of information provided.

The content elements

6.28 The various content elements required[15] to be included in the strategic report should not be addressed in isolation; there are numerous relationships and interdependencies between elements and other disclosures in the annual report which, as noted in paragraph 6.21, should be highlighted in the strategic report.

6.29 The relevance and strength of the relationships and interdependencies between the content elements will vary according to the facts and circumstances of the entity.

6.30 Objectives, strategy and business model are inter-related concepts. An entity will decide on its objectives and select strategies to achieve those objectives. An entity will then apply its business model to its activities in pursuit of its objectives and strategies. The disclosure of an entity's objectives, strategy and business model should together explain what an entity does and how and why it does it.

6.31 **The strategic report should include a description of the entity's principal objectives and its strategies for achieving those objectives[16].**

6.32 An entity will normally have set a number of formal objectives describing what it intends to achieve. In addition, the entity will also have developed explicit strategies that describe the means by which it intends to achieve its objectives.

6.33 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.

6.34 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.

6.35 The description of an entity's strategies allows shareholders to assess the current and past actions undertaken by the directors in pursuit of the entity's objectives and to predict future developments in the business.

[15] As noted in paragraph 2.1, this [draft] guidance has been written with quoted companies in mind. Certain content elements described in this section of the [draft] guidance are not mandatory for companies that do not meet the definition of a quoted company. Appendix II sets out which strategic report requirements apply to companies that are not quoted companies.

[16] Section 414C(8)(a) of the Act

6.36 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.

Linkage example

The identification of the business segments to which the principal objectives and strategies relate and a subsequent discussion of what exactly the entity hopes to achieve will provide a clear sense of the strategic direction of the key parts of the business.

6.37 **The strategic report should include a description of the entity's business model[17].**

6.38 The description of the entity's business model should set out how it generates or preserves value, and how it captures that value. It should describe, at a high level, what the entity does and why it does it (ie what makes it different from, or the basis on which it competes with, its peers).

6.39 The description of the business model should provide shareholders with an understanding of how the entity is structured, the market in which it operates, and how the entity engages with that market (eg what part of the value chain it operates in, its main products, services, customers and its distribution methods). It should also describe the nature of the relationships, resources and other inputs that are necessary for the successful continuation of the business.

Linkage example

The description of the business model could be used to signpost other relevant information in the strategic report. It could also highlight the principal risks that could affect a specific part of the business model.

6.40 The description of the business model should set out the parts of the entity's business process that are most important to the generation, preservation or capture of value.

Example

Many businesses will have a customer focus. However, some businesses might have a greater focus on an earlier stage of the value creation process. For example, an entity operating in the pharmaceuticals sector might have a ready market for an innovative drug; the key to the value creation process is in the development and approval of that drug. In this case the business model description should give due emphasis to the critical drug development and approval processes.

6.41 A description of the business model provides context for the annual report as a cohesive document.

[17] Section 414C(8)(b) of the Act

6.42 **To the extent necessary for an understanding of the development, performance or position of the entity's business, the strategic report should include the main trends and factors likely to affect the future development, performance or position of the business[18].**

6.43 Trends and factors affecting the business may arise either as a result of the external environment in which the entity operates or from internal sources.

Linkage example

The reasons for the entity adopting its principal objectives and strategies (and the business model) may be clarified through a linkage to a description of trends and factors affecting an entity.

6.44 The development, performance and position of every entity is affected by its external environment. The strategic report should include a description of the entity's major markets and its competitive position within those markets. It should cover the significant features of the legal, regulatory, macro-economic and social environment in which the entity operates, and how that has influenced the business. It should also set out the directors' analysis of the potential effect on the future development, performance or position of the entity of the trends or factors identified.

6.45 Where practicable and relevant, the trend or factor should be quantified and the source of the evidence underpinning it identified.

Example

An entity may wish to state in its strategic report that the market in which it operates has grown substantially in the past five years. In this case, the strategic report should, where practicable, indicate by how much the market has grown and provide a link to the research or report from which the statistic has been taken.

6.46 The strategic report should discuss internal trends and factors likely to affect the future development, performance or position of the entity. These will vary according to the nature of the business, but could, for example, include the development of new products and services or the benefits expected from capital investment.

6.47 Directors should consider the potential future significance of trends or factors in deciding whether or not to include an analysis of them in the strategic report.

6.48 Given the influence trends and factors might have on many aspects of the entity's development, performance or position, the linkage of this type of information to other areas of the strategic report and the annual report more widely will be particularly important.

Linkage example

The strategic report might highlight any principal risks or opportunities that arise from, and strategies that have been adopted as a result of, the significant trend or factor identified.

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[18] Section 414C(7)(a) of the Act

6.49 **The strategic report should include a description of the principal risks and uncertainties facing the entity[19], together with an explanation of how they are managed or mitigated.**

6.50 The risks and uncertainties included in the strategic report should be limited to those considered by the entity's management to be the most important to the future development, performance or position of the entity. They will generally be matters that the directors regularly monitor and discuss because of their likelihood, the magnitude of their potential effect on the entity, or a combination of the two.

6.51 Principal risks or uncertainties with potential effects of such a magnitude that they may threaten the entity's viability (ie its solvency and/or liquidity) should be explained fully and given due prominence.

6.52 Directors should consider the full range of business risks including commercial, operational and financial risks. Principal risks should be disclosed and described irrespective of how they are classified or whether they result from strategic decisions, operations, organisation or behaviour, or from external factors over which the board may have little or no direct control.

6.53 The descriptions of the principal risks and uncertainties facing the entity should be sufficiently specific that a shareholder can understand why they are important to the entity. This might include a description of the likelihood of the risk, an indication of when the risk might be most relevant to the entity and its possible effects. Significant changes in principal risks such as a change in likelihood or possible effect, or the inclusion of new risks, should be highlighted and explained. An explanation of how the principal risks and uncertainties are managed or mitigated should also be included.

Example

It could be useful to explain the change in risk profile since the previous year and how the entity has responded to this change in terms of its risk mitigation.

Linkage example

The disclosure of the reporting and monitoring process for each risk, explaining the entity's risk appetite, how often the risk is reviewed, and by whom, could enhance linkage to information in the corporate governance report (eg the internal control statement or the audit committee report).

[19] Section 414C(2)(b) of the Act

6.54 A risk or uncertainty may be unique to the entity, a matter that is relevant to the market in which it operates, or something that applies to the business environment more generally. Where the risk or uncertainty is more generic, the description should make clear how it might affect the entity specifically.

> ***Linkage example***
>
> Where relevant, the description of the principal risks and uncertainties facing the entity should include linkage to and discussion of the entity's strategies, business model and key performance indicators. Any linkage to accounting estimates and judgements disclosed in the notes to the financial statements, trends or factors from the external environment described elsewhere in the strategic report, or any other linked disclosure in the annual report, could also be highlighted and, where relevant, discussed.

6.55 **The analysis in the strategic report should include the financial and non-financial key performance indicators (KPIs)[20] utilised by the directors to measure progress towards achieving a particular objective or strategy.**

6.56 The KPIs used in the analysis should be those that the directors judge are most effective in assessing progress against objectives or strategies. Where possible, they should be accepted and widely used, either within the entity's industry sector or more generally.

> ***Linkage example***
>
> The use of KPIs in relation to an entity's strategies will clearly show the progress an entity has made towards achieving its objectives or strategies.

> ***Linkage example***
>
> Highlighting those KPIs which form part of directors' incentive plans, along with links to principal risks, provides an overview of how the performance of the business is related to executive remuneration.

6.57 Comparatives should be included for KPIs and the reasons for any significant changes from year to year explained.

6.58 The entity should provide information that enables shareholders to understand each KPI used in the strategic report. For example, the following information should be identified and explained where relevant:

(a) its definition and calculation method;

(b) its purpose;

(c) the source of underlying data;

(d) any significant assumptions made; and

(e) any changes in the calculation method used compared to previous financial years, including significant changes in the underlying accounting policies adopted in the financial statements which might affect the KPI.

[20] Section 414C(4) of the Act

6.59 Where a line-item from the financial statements, or a commonly used KPI, has been adjusted for inclusion in the strategic report, the term used for that adjusted measure should be clear and, where practicable, a reconciliation to an appropriate financial statement line-item and explanation of any adjustments should be provided.

> ***Example***
>
> Where an entity uses earnings before interest, tax, depreciation, amortisation (EBITDA) and certain restructuring costs as a KPI, the measure could be referred to as 'Adjusted EBITDA' or similar and a reconciliation to an appropriate financial statement line-item and explanation of the adjustment provided.

6.60 **The strategic report should provide an analysis of the development and performance of the business in the financial year and of its position at the end of that year[21].**

6.61 The analysis should supplement the financial statements, where relevant providing additional explanations of amounts recognised in the financial statements and the conditions and events that shaped the information contained in them[22]. It should aim to answer the questions that are commonly asked by shareholders at an Annual General Meeting (AGM) or at results presentations.

> ***Example***
>
> The strategic report often in a financial review might, where relevant, include comments on:
>
> - the existence and timing of commitments for capital expenditures; or
> - changes in revenue from year to year that result from organic growth, acquisitions, foreign exchange, etc (a 'revenue bridge'); or
> - financing arrangements (eg changes in net debt or approach to financing of long-term liabilities).

6.62 The analysis should make reference to cash flows during the year and factors that may affect future cash flows. Where appropriate, the strategic report should discuss the entity's current and prospective liquidity and its ability to fund its stated strategies.

6.63 The strategic report should set out the key strengths and tangible and intangible resources available to the entity, which will assist it in the pursuit of its objectives. Particular attention should be given to those items that are not reflected in the financial statements. Depending on the nature of the business, these may include: corporate reputation and brand strength; natural resources; employees; research and development; intellectual capital; licences, patents, copyrights and trademarks; and market position.

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[21] Section 414C(2)(a) and (3) of the Act
[22] Section 414C(12) of the Act

6.64 **To the extent necessary for an understanding of the development, performance or position of the entity's business, the strategic report should include information about:**

(a) environmental matters (including the impact of the business of the entity on the environment)[23];

(b) the entity's employees[24]; and

(c) social, community and human rights issues[25].

6.65 There may be a strong relationship between the development, performance, position or future prospects and the matters described in paragraph 6.64, particularly over the longer term. The strategic report should include information on these matters when their influence, or potential influence, on the development, performance, position or future prospects of the entity's business is of such a nature or magnitude that they are relevant to shareholders. The strategic report should not, however, be seen as a replacement for other forms of reporting addressed to other stakeholders.

Linkage example

The way an entity conducts its business in relation to the issues in paragraph 6.64 may affect its licence to operate/trade in a particular location or market, or result in a major event that will directly or indirectly affect the entity (eg a material litigation, loss of revenue or reparation cost). The risk of such an event may constitute a principal risk or uncertainty to the entity.

Linkage example

The identification of the key inputs and outputs of the business, together with the key stakeholder relationships could be linked to the business model and strategies to help explain the reasons why each particular matter or issue is important to the business.

6.66 Where this information is material it should be placed in the strategic report. If the directors consider that this type of information is important but not material to shareholders, the information could be located elsewhere, for example, in a sustainability report.

[23] Section 414C(7)(b)(i) of the Act
[24] Section 414C(7)(b)(ii) of the Act
[25] Section 414C(7)(b)(iii) of the Act

6.67 Where a discussion of an issue related to any of the matters described in paragraph 6.64 is considered necessary for an understanding of the development, performance, position or future prospects of the entity's business, the strategic report should make clear why it is considered necessary. It should also include information on the policies of the entity on those matters and the effectiveness of those policies[26].

> ***Example***
>
> An entity that sources its products from overseas could face risks relating to stakeholder (eg customer) concerns relating to local labour practices. In this situation, the entity might have put in place a system to validate and monitor supply chain performance, specifically related to adherence to stated policies. The directors might also monitor the effectiveness of those policies with KPIs. Where the nature or magnitude of the potential effect of the risk on the business is such that it would be of interest to shareholders, it should be described and discussed in the strategic report.

6.68 **The strategic report should provide a breakdown showing, as at the end of the financial year[27]:**

(a) the number of persons of each sex who were directors of the company;

(b) the number of persons of each sex who were senior managers of the entity (other than persons falling within sub-paragraph (a)); and

(c) the number of persons of each sex who were employees of the entity.

6.69 A senior manager means an employee who is a director of a subsidiary of the company or who otherwise has responsibility for planning, directing or controlling the activities of the entity or a strategically significant part of it[28].

6.70 In referring to a 'strategically significant' part of an entity and by including directors of all subsidiaries, the definition of a 'senior manager' in paragraph 6.69 is wider than the definition of Key Management Personnel (KMP) in IAS 24 *Related Party Disclosures* and FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. It may, for example, include employees who have responsibility for planning, directing or controlling the activities of a reportable segment.

6.71 The analysis required by paragraph 6.68(b) should enable shareholders to ascertain the number of persons of each sex who might, in due course, attain a position that would be classified under paragraph 6.68(a) or an equivalent position.

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[26] Section 414C(7)(b) of the Act
[27] Section 414C(8)(c) of the Act
[28] Section 414C(9) & (10) of the Act

6.72 **To the extent that they are matters which are considered to be of strategic importance to the entity, the strategic report should also include information which would otherwise be disclosed in the directors' report[29].**

6.73 Where information that is required to be disclosed in the directors' report is included in the strategic report, it does not also need to be included in the directors' report (whether by cross-reference or otherwise). However, where this is the case, the directors' report should identify which information has been included in the strategic report instead of the directors' report[30].

[29] Section 414C(11) of the Act

[30] Section 1A of the Large and Medium-sized Companies and Groups (Reports and Accounts) Regulations 2008

The Accounting Council's Advice to the FRC to issue *Exposure Draft: Guidance on the Strategic Report*

Introduction

1. This report provides an overview of the main issues that have been considered by the Accounting Council in advising the FRC to issue the draft *Guidance on the Strategic Report*.

2. As part of the development of the guidance, the Accounting Council was keen to obtain input from investors and preparers at an early stage. The Accounting Council therefore set up a Narrative Reporting Advisory Panel (Advisory Panel) to facilitate the process. As well as investors and preparers, the Advisory Panel included auditors, representatives from the Department for Business, Innovation and Skills (BIS) and the International Integrated Reporting Council (IIRC) as well as representatives from the FRC's Corporate Governance, Corporate Reporting Review and Financial Reporting Lab teams. The FRC is grateful to the members of the Advisory Panel for their input during the development of this draft guidance.

Advice

3. The Accounting Council is advising the Financial Reporting Council (FRC) to issue *Exposure Draft: Guidance on the Strategic Report*.

Background

4. BIS has asked the FRC to prepare non-mandatory guidance on the application of the strategic report requirements introduced into **the Act** by the *Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013* (the Regulations). Separate guidance on the application of the mandatory greenhouse gas (GHG) emissions reporting required by the Regulations has been published by the Department for Environment Food & Rural Affairs (DEFRA)[31].

5. The final *Guidance on the Strategic Report* will replace the Accounting Standards Board's *Reporting Statement: Operating and Financial Review* (RS).

6. When developing the proposed guidance, the FRC was mindful of developments in Integrated Reporting. In contrast to an integrated report, the strategic report is required as part of the annual report in the UK, with its purpose and content largely determined by legislation. This fact notwithstanding, the proposed *International Integrated Reporting Framework* and the draft *Guidance on the Strategic Report* encourage similar qualitative characteristics and content. The draft *Guidance on the Strategic Report* is also broadly consistent with the guidance in the International Accounting Standards Board's (IASB) IFRS Practice Statement *Management Commentary*.

Objectives

7. The FRC is committed to improving the quality of financial reporting and would like to encourage annual reports to be more relevant to the needs of shareholders. The FRC's projects on the disclosure framework and cutting clutter are a step towards this goal and the draft *Guidance on the Strategic Report* will also contribute to achieving this aim.

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[31] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/206392/pb13944-env-reporting-guidance.pdf

8. In developing the draft guidance, the Accounting Council has drawn on the feedback received from the FRC's recent Discussion Paper *Thinking about Disclosures in a Broader Context*. That paper has a broad scope which includes disclosures in narrative reports. The paper noted that providing disclosures should be a communication rather than a compliance exercise; it considered issues such as the application of materiality to disclosures and highlighted the challenges caused by different authoritative sources setting disclosure requirements. While it is not possible to address all of the problems with disclosures in a single piece of non-mandatory guidance, the Accounting Council believes that improving disclosures in narrative reports will be a step in the right direction.

9. The objectives that the Accounting Council have set for the draft *Guidance on the Strategic Report* are intended to ensure that the draft guidance helps entities to prepare strategic reports, and annual reports more generally, that: (a) are focused on the needs of shareholders; (b) tell a cohesive story of the business; and, (c) make full use of the flexibility that exists within the regulatory framework.

10. The Accounting Council believes that the draft *Guidance on the Strategic Report* should draw on, but not be bound by, the guidance in the RS.

Scope

11. With the introduction of the strategic report, the Accounting Council believes there is an opportunity to make the annual report as a whole, a more cohesive document. It believes that this can only be achieved by setting the strategic report, and narrative reports more generally, in the context of the annual report as a whole. Therefore, the Accounting Council suggested that the scope of the guidance should go beyond the strategic report, emphasising linkages between narrative reporting with other parts of the annual report.

The Companies Act 2006 directors' report and strategic report requirements

12. Although this draft guidance is written with quoted companies in mind, it is also intended to serve as best practice guidance for other entities preparing their strategic reports. The tables in Appendix II and Appendix III are intended to allow companies to quickly identify the legal requirements that are relevant to their own particular status.

The annual report

13. The Accounting Council believes that to set the guidance in context, it is necessary to understand the purpose of the annual report and the objectives of each component of the annual report as this helps users of the draft guidance to make judgements regarding where and how information is best presented.

14. The Accounting Council considers that Illustration 1 is useful in setting the context, clarifying the purpose of each part of the annual report.

15. In developing the objectives set out in Illustration 1, the Accounting Council intended to build on concepts that have already been developed by the FRC or the IASB. Therefore, the purpose of the annual report is as set out in the FRC's 2009 Discussion Paper *Louder than Words* and is not inconsistent with the IASB's objective of financial reporting as set out in its *Conceptual Framework for Financial Reporting*.

16. The objectives for each of the components of the annual report – narrative reports, corporate governance statements and the financial statements – are based on those set out in The FRC's October 2012 Discussion Paper *Thinking about Disclosures in a Broader Context* and developed through consultation with the Advisory Panel.

17. The Accounting Council acknowledges that a risk associated with a graphical illustration of an annual report, or indeed any systematic description of the parts and purpose of an annual report, is that it implies a desired or preferred structure for all annual reports. This is emphatically not the case. The Accounting Council believes that it is of the utmost importance that an annual report is drafted and structured in such a way that, as well as being compliant with all of the relevant laws and regulations, it is fair, balanced and understandable. It encourages companies to consider and challenge the 'traditional' structure of the annual report with an objective of organising information so that it is informative to investors and a valuable communication tool.

18. During the development of the draft guidance, the Accounting Council considered a concern that the illustration does not include reference to a chairman's statement when **the Code** specifically encourages a personal statement from the chairman. Similarly, it does not include financial highlights, a Chief Executive Officer's report, or a sustainability report, all of which are commonly found in annual reports today. The Accounting Council noted that the illustration is intended to show the minimum requirements and that to include these items might result in a greater risk that companies would see the illustration as being more structurally prescriptive than is intended.

Interaction with corporate governance reporting

19. There is some overlap between the content and qualitative characteristics of information required by the Act and the information required by the Code. For example, provision C.1.1 of the Code states that it should provide 'the information necessary for shareholders to assess the company's performance, business model and strategy'.

20. The requirement for an annual report to be 'fair, balanced and understandable' also arises from provision C.1.1 of the Code. As businesses and the business environment become ever more complex and fast-moving, so the need to tell the company's story in as simple and accessible way as possible becomes more acute. The Accounting Council thinks that it is important to note that the strategic report plays a very important role in ensuring that the annual report, when taken as a whole, is fair, balanced and understandable.

21. The objectives for the directors' remuneration section were based on *Directors' Pay: Consultation on revised remuneration reporting regulations'* (BIS, June 2012).

Who are the users of strategic reports?

22. Section 414C(1) of the Act states that the legal addressee of the strategic report is the members of the company. In consequence, paragraph 3.6 acknowledges that their needs are paramount (members are referred to in the draft guidance as the 'shareholders'). However, the Accounting Council believes that the needs of a wider investor group than simply current shareholders should be borne in mind when the annual report is being drafted; preparers should consider the needs of other investors (including debt investors) and potential investors, and their advisers, as well as current shareholders.

23. Paragraph 22 notwithstanding, the Accounting Council believes that a narrow definition of users is necessary to ensure that annual reports provide information that is relevant to shareholders and, in turn, assist in cutting clutter. In consequence, the draft guidance makes clear that the annual report should not be seen as a replacement for other forms of reporting addressed to other stakeholders.

Placement of information in the annual report

24. The Accounting Council believes that reviewing the placement of information that is usually contained within an annual report might contribute towards the reduction of clutter. The Accounting Council would like to encourage an approach whereby core information (from an investor's perspective) is given prominence and supplementary information is located elsewhere. Currently, certain information is required to be presented in an annual report and there are legal barriers that prevent moving information elsewhere (eg online). However, as an interim step the Accounting Council considers that supplementary information could be positioned in an appendix so that it does not detract from the core information. In future, it hopes that some of the legal barriers can be removed.

25. One challenge the recommendations in paragraph 3.12 pose is ensuring that there is clarity regarding the information that is and is not subject to audit. The Accounting Council acknowledges that preparers will need to be particularly careful in this respect if they elect to cross-refer to information that is included in an appendix to the annual report or outside of the annual report altogether.

Strategic reports and materiality

26. The Accounting Council believes that the application of the concept of materiality is a key issue for narrative reporting. The inclusion in the annual report of narrative information that is not relevant to investors, and is not otherwise required by law or regulation, is considered a key driver of 'clutter'. In addressing the issue of materiality in a separate section, as well as embedding references within other sections, the Accounting Council is attempting to give the consideration of materiality a renewed prominence in the context of narrative reporting.

27. While the changes introduced by the Regulations represent a relatively modest change to the pre-existing legal requirements, the Accounting Council hopes that they might act as a catalyst for companies to revisit their policies and practices with a view to preparing relevant and focused narrative reports. This section provides guidance on the level of detail that should be included in the strategic report; it may result in some companies eliminating some detail previously included in the business review section of their annual report.

The strategic report

28. During the course of the development of this draft *Guidance on the Strategic Report*, the Accounting Council became aware of a commonly held misconception that the strategic report would be an additional higher-level summary of information contained within the annual report; that it would contain only 'strategically important' information which may be of a different level of materiality or importance to the information currently included in the business review. However, the purpose and required content of the strategic report does not differ significantly from that of the business review which it replaces.

29. The Accounting Council intends that the three content-related objectives of the strategic report set out in paragraph 6.2 ensure that the purpose of the strategic report, as defined by the Act, is met. In achieving these objectives, the Accounting Council believes that the strategic report will play its part in the overall objective of the annual report which is to provide information that is useful for making resource allocation decisions and for assessing management's stewardship.

30. The fourth objective, set out in paragraph 6.3, reflects the importance that the Accounting Council attaches to the view that one role of the strategic report is to be an aide to navigation around the myriad of corporate information that is available about an entity. The Accounting Council holds the view that this should facilitate 'drill-down' to further detail elsewhere in the annual report and beyond.

Communication principles

31. As the draft *Guidance on the Strategic Report* is focused on the strategic report, the Accounting Council has drafted the communication principles to provide guidance on qualitative characteristics that are specific to the strategic report. It acknowledges, however, that they will also be relevant in the drafting of the annual report as a whole. The qualities described in this part of the draft guidance are generally those which were highlighted as desirable by investors. In some cases, however, the qualities also have a legal or regulatory source.

32. The Code requires the annual report as a whole to be fair, balanced and understandable. However, whereas the Act requires the strategic report to be both fair and balanced, there is no similarly direct requirement for it also to be understandable. The Accounting Council considers that, given the annual report, when taken as a whole, must be fair, balanced and understandable, the strategic report section must also have the same characteristics.

33. The Accounting Council has included the reference to ‘comprehensive’ in paragraph 6.15 because it is an explicit requirement of the Act. Its inclusion does not conflict with the recommendation that the strategic report should also be concise as the Accounting Council has interpreted comprehensive, in this respect, to be a function of breadth of information rather than depth of information. The depth of information on any particular subject should be a function of materiality, which is considered in Section 5 of the draft guidance.

34. The Accounting Council intends the reference to ‘short-, medium- and long-term’ to indicate that the strategic report should not concentrate solely on a single timeframe (eg it should not just consider the short-term). Information in the strategic report should not necessarily be categorised or organised in this way, although the timescale associated with a particular fact or circumstance may be relevant information to disclose.

35. Effective linkage enhances the usefulness of individual pieces of information in an annual report and increases their relevance to investors. The Accounting Council considers that ‘linkage’ is a key quality for investors.

36. During the development of the draft guidance, the Accounting Council considered the inclusion of a communication principle recommending that the structure and presentation of the strategic report should remain consistent from year to year unless a change represented an improvement of the communication of the information contained in the strategic report. Although consistency from year to year was a quality investors desired, the Accounting Council concluded that an emphasis on consistency might inhibit the more general communication improvements that are seen as a priority. ‘Change for change’s sake’ is discouraged.

Content elements

37. The government has a policy of no ‘gold-plating’ (the practice of exceeding the terms of European Commission directives when implementing them into national law). In line with this policy, the wording of the bold content elements set out in Section 6 is based on that used in the Act. In a limited number of cases, however, it has been necessary to clarify the language used in the Act to improve understandability.

38. The content elements are supplemented with supporting detail that describes the nature of information that the Accounting Council believes should be considered for disclosure in respect of each requirement.

39. The Accounting Council wishes to provide some guidance on how information might be presented in the strategic report without being seen to be too prescriptive regarding its structure or content. It has sought to achieve this by highlighting examples of the way in which the content elements might be combined or interact with each other; these examples are set out in the 'linkage example' boxes within the content element guidance.

Objectives, strategies and business model

40. Provision C.1.2 of the Code describes a business model as 'the basis on which the company generates or preserves value over the longer term'. The definition used in the guidance is consistent with the Code.

41. During the development of the guidance, preparers and investors indicated that it is important that the description of the business model explains how the entity differs from its competitors.

42. The Accounting Council believes that it is important for investors to understand how the value generated by the business activities is captured and converted into financial benefits. This quality of a business model description has been added into the content element guidance.

43. The Accounting Council acknowledges that different businesses use different terms for business model, objectives and strategies. Distinguishing between these terms can be challenging. It is difficult to reach consensus on how the concepts should be differentiated as they are inextricably linked. Preparers and the Advisory Panel, however, indicated that this is an area that is difficult to apply and on which guidance would be helpful. The Accounting Council also notes that the Act treats the business model and strategy as separate concepts.

44. Entities could apply a different order to the three concepts when presenting this information in their annual report. The Accounting Council also does not intend to imply that other definitions or terminology should not be used in the strategic report.

Principal risks

45. The definition of a principal risk, and the language used in the guidance paragraphs under the principal risks content element has been developed taking into account the FRC's review of its guidance on risks and going concern arising from the Sharman Inquiry. The Accounting Council acknowledges that this wording may be subject to change as the FRC issues further consultations relating to the implementation of the Sharman recommendations.

46. Taking decisions on how a company should approach the principal risks it faces is a fundamental part of the duties of a director. Information on how the principal risks are managed is therefore important to shareholders when making resource allocation decisions and assessing management's stewardship. In consequence, the Accounting Council believes that such information should be included in the strategic report. Where a company has a non-UK listing (eg on the New York Stock Exchange or NASDAQ), directors will need to consider the regulatory requirements in those jurisdictions before including this information in their overseas filings.

Appendix I: Glossary

the Act	The Companies Act 2006
annual report	The annual accounts and reports that members of the company are entitled to receive under s423 of **the Act**, generally comprising the **narrative reports**, corporate governance statements and the financial statements.
business model	How the entity generates or preserves value over the longer term[32].
the Code	The 2012 UK Corporate Governance Code.
directors' report	The report that is required by s415 of the Act which incorporates the disclosures specified by the Act or its associated regulations.
DTR	The Disclosure and Transparency Rules.
key performance indicators (KPIs)	Factors utilised by the directors to measure progress towards achieving a particular objective or objectives, or strategies.
LR	The London Stock Exchange Listing Rules.
materiality (as applied to strategic reports)	Information is material if omitting or misrepresenting it might reasonably be expected to influence the economic decisions shareholders make on the basis of the annual report as a whole. Materiality depends on the nature and the magnitude of effect of the fact or circumstance to which the information relates on the entity's development, performance, position or future prospects, judged in the surrounding circumstances. The nature or the magnitude of effect, or a combination of both, could be the determining factor. The inclusion of immaterial information can obscure key messages and impair understandability of information provided. In such circumstances, the immaterial information should be excluded.
narrative reports	The **strategic report** and the **directors' report**.
objectives	Specific goals describing what the entity wishes to achieve.
principal risk	A risk or combination of risks that can seriously affect the performance, future prospects or reputation of the entity. These should include those risks that affect the viability of an entity.

[32] **The Code**, Provision C.1.2

quoted company	A company whose equity share capital has been included in the official list in accordance with the provisions of Part 6 of the Financial Services and Markets Act 2000; or is officially listed in an EEA State; or is admitted to dealing on either the New York Stock Exchange or the exchange known as NASDAQ[33].
strategic report	The report, required by s414C of the Act, which provides shareholders of the company with the ability to assess how the directors have performed their duty under s172 (duty to promote the success of the company).
strategy	A plan or approach which is intended to help the entity achieve an objective or **objectives**.

[33] Section 385 of the Act

Appendix II
The Companies Act 2006 strategic report disclosure requirements

The following table summarises the disclosure requirements of **the Act** in respect of the strategic report.

Reference	Requirement	Quoted public company	Other public company including AIM	Large and medium-sized private company	Small private company
s414C(1)	The purpose of the strategic report is to inform members of the company and helps them to assess how the directors have performed their duty under s172 (duty to promote the success of the company).	✓	✓	✓ (Except those that would be small if not in an ineligible group – s414B)	×
s414C(2)(a)	The strategic report must contain a fair review of the company's business.	✓	✓		×
s414C(2)(b)	The strategic report must contain a description of the principal risks and uncertainties facing the company.	✓	✓		×
s414C(3)	The review required is a balanced and comprehensive analysis of the development and performance of the company's business during the financial year, and the position of the company's business at the end of that year, consistent with the size and complexity of the business.	✓	✓		×

Reference	Requirement	Quoted public company	Other public company including AIM	Large and medium-sized private company	Small private company
	The review must, to the extent necessary for an understanding of the development, performance or position of the company's business, include:				
s414C(4)(a)	(i) analysis using financial key performance indicators; and	✓	✓	✓ (Except those that would be small if not in an ineligible group – s414B)	×
s414C(4)(b)	(ii) where appropriate, analysis using other key performance indicators, including information relating to environmental matters and employee matters.	✓	✓	✓ (Large companies only – s414C(6))	×
s414C(7)(a)	The strategic report must, to the extent necessary for an understanding of the development, performance or position of the company's business, include the main trends and factors likely to affect future development, performance and position.	✓	×	×	×

Reference	Requirement	Quoted public company	Other public company including AIM	Large and medium-sized private company	Small private company
s414C(7)(b)	The strategic report must, to the extent necessary for an understanding of the development, performance or position of the company's business, information about: (i) environmental matters (including the impact of the company's business on the environment); (ii) the company's employees; and (iii) social, community and human rights issues including information about any policies of the company in relation to those matters and the effectiveness of those policies. If the report does not contain information of each kind mentioned in s414C(7)(b)(i), (ii) or (iii), it must state which of those kinds of information it does not contain.	✓	×	×	×
s414C(8)(a)	The strategic report must include a description of the company's strategy.	✓	×	×	×
s414C(8)(b)	The strategic report must include a description of the company's business model.	✓	×	×	×

Reference	Requirement	Quoted public company	Other public company including AIM	Large and medium-sized private company	Small private company
s414C(8)(c), (9) & (10)	The strategic report must include a breakdown showing at the end of the financial year: (i) the number of persons of each sex who were directors of the [parent] company; (ii) the number of persons of each sex who were senior managers of the company (other than persons falling within sub-paragraph (i)) [or who were directors of undertakings included in the consolidation]; and (iii) the number of persons of each sex who were employees of the company. A senior manager is an employee of the company who has responsibility for planning, directing or controlling the activities of the company, or a strategically significant part of the company.	✓	×	×	×
s414C(11)	The strategic report may also contain such matters otherwise required by regulations made under s416(4) to be disclosed in the directors' report as the directors consider are of strategic importance to the company.	✓	✓	✓ (Except those that would be small if not in an ineligible group – s414B)	×
s414C(12)	The report must, where appropriate, include references to, and additional explanations of, amounts included in the company's annual accounts.	✓	✓		×
s414A(4) & s414C(13)	A group strategic report may, where appropriate, give greater emphasis to the matters that are significant to the undertakings included in the consolidation, when taken as a whole. With the exception of the disclosures required by s414C(8), in relation to a group strategic report s414C has effect as if the references to the company were references to the undertakings included in the consolidation.	✓	✓		×

<table>
<tr><th>Reference</th><th>Requirement</th><th>Quoted public company</th><th>Other public company including AIM</th><th>Large and medium-sized private company</th><th>Small private company</th></tr>
<tr><td>s414C(14)</td><td>Nothing in s414C requires the disclosure of information about impending developments or matters in the course of negotiation if the disclosure would, in the opinion of the directors, be seriously prejudicial to the interests of the company.</td><td>✓</td><td>✓</td><td rowspan="2">✓
(Except those that would be small if not in an ineligible group – s414B)</td><td>×</td></tr>
<tr><td>s414D(1)</td><td>The strategic report must be approved by the board and signed on behalf of the board by a director or the secretary of the company.</td><td>✓</td><td>✓</td><td>×</td></tr>
</table>

Appendix III
The Companies Act 2006 directors' report disclosure requirements

The following tables summarise the disclosure requirements of **the Act** and its associated regulations in respect of the directors' report.

Companies Act 2006 reference	Requirement	Quoted public company	Other public company including AIM	Large and medium-sized private company	Small private company
s236	Statement of the existence, at any time during the financial year to which a directors' report relates or when the directors' report is approved, of qualifying indemnity provisions (whether made by the company or otherwise) for the benefit of one or more directors of the company or directors of an associated company.	✓	✓	✓	✓
s416(1)	The names of the persons who, at any time during the financial year, were directors of the company.	✓	✓	✓	✓
s416(3)	The amount (if any) that the directors recommend should be paid by way of a dividend.	✓	✓	✓ (Except those that would be small if not in an ineligible group – s415A)	×

Companies Act 2006 reference	Requirement	Quoted public company	Other public company including AIM	Large and medium-sized private company	Small private company
s418(2)	A statement to the effect that, in the case of each of the persons who are directors at the time the report is approved, (a) so far as the director is aware, there is no relevant audit information of which the company's auditor is unaware, and (b) he has taken all the steps that he ought to have taken as a director in order to make himself aware of any relevant audit information and to establish that the company's auditor is aware of that information.	✓	✓	✓	✓ (If audited)
s419(1)	Approval by the board of directors and signature on behalf of the board by a director or the secretary of the company.	✓	✓	✓	✓
s419(2)	If in preparing the report advantage is taken of the small companies' exemption, the directors' report must contain a statement to that effect in a prominent position above the signature.	×	×	× (Except those that would be small if not in an ineligible group – s415A)	✓

Regulations[34] reference	Requirement	Quoted public company	Other public company including AIM	Large and medium-sized private company	Small private company
Sch 7.1A	Identification of the information for which the company has chosen, in accordance with s414C(11) of the Companies Act, to set out in the company's strategic report which would otherwise be required by Schedule 7 of the 'Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008' to be contained in the directors' report.	✓	✓	✓	×
Sch 7.3(2) & 4(1) Sch 5.2(2) & 3(1)	Information on political donations made or political expenditure incurred by the company or its subsidiaries, if in excess of £2,000 in aggregate.	✓ (Other than wholly owned subsidiaries of UK-incorporated companies)	✓ (Other than wholly owned subsidiaries of UK-incorporated companies)	✓ (Other than wholly owned subsidiaries of UK-incorporated companies)	✓ (Other than wholly owned subsidiaries of UK-incorporated companies)
Sch 7.6(1)(a)	Unless the information is not material for an assessment of the assets, liabilities, financial position and profit or loss of the company (and any subsidiaries included in its consolidation), an indication of financial risk management objectives and policies, including the policy for hedging each major type of forecasted transaction for which hedge accounting is used.	✓	✓	✓	×
Sch 7.6(1)(b)	Unless the information is not material for an assessment of the assets, liabilities, financial position and profit or loss of the company (and any subsidiaries included in its consolidation), an indication of exposure to price risk, credit risk, liquidity risk and cash flow risk.	✓	✓	✓	×

[34] In the case of a medium-sized or large company, Schedule 7 of the 'Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008'. In the case of small companies, Schedule 5 of the 'Small Companies and Groups (Accounts and Directors' Reports) Regulations 2008'.

Regulations reference	Requirement	Quoted public company	Other public company including AIM	Large and medium-sized private company	Small private company
Sch 7.7(1)(a)	Details of any important events affecting the company (and any subsidiaries included in its consolidation) since the end of the financial year.	✓	✓	✓	×
Sch 7.7(1)(b)	An indication of likely future developments in the business of the company (and any subsidiaries included in its consolidation).	✓	✓	✓	×
Sch 7.7(1)(c)	An indication of activities (if any) of the company (and any subsidiaries included in its consolidation) in the field of research and development.	✓	✓	✓	×
Sch 7.7(1)(d)	Unless the company is an unlimited company, an indication of the existence of branches (as defined in s1046(3) of the Companies Act 2006) of the company outside of the United Kingdom.	✓	✓	✓	×
Sch 7.9	Information on the acquisition of own shares.	✓	✓	×	×

Regulations reference	Requirement	Quoted public company	Other public company including AIM	Large and medium-sized private company	Small private company
Sch 7.10(3) Sch 5.5(3)	A statement describing the company’s policy regarding the hiring, continuing employment and training, career development and promotion of disabled persons.	✓ (Where the weekly average number of employees exceeds 250)	✓ (Where the weekly average number of employees exceeds 250)	✓ (Where the weekly average number of employees exceeds 250)	✓ (Where the weekly average number of employees exceeds 250)
Sch 7.11(3)	For employees working wholly or mainly in the UK, a description of the action that has been taken during the financial year to introduce, maintain or develop arrangements aimed at: (a) providing employees systematically with information on matters of concern to them as employees; (b) consulting employees or their representatives on a regular basis so that the views of employees can be taken into account in making decisions which are likely to affect their interests; (c) encouraging the involvement of employees in the company’s performance through an employees’ share scheme or by some other means; (d) achieving a common awareness on the part of all employees of the financial and economic factors affecting the performance of the company.	✓ (Where the weekly average number of UK-based employees exceeds 250)	✓ (Where the weekly average number of UK-based employees exceeds 250)	✓ (Where the weekly average number of UK-based employees exceeds 250)	×

Regulations reference	Requirement	Quoted public company	Other public company including AIM	Large and medium-sized private company	Small private company
Sch 7.13(2) & 14	Detailed information, including any necessary explanatory material with regard to that information, on matters including: (a) the structure of the company's capital (including securities not admitted to trading on a regulated market); (b) any restrictions on the transfer of securities in the company; (c) persons with a significant direct or indirect holding of securities in the company; (d) persons who hold securities carrying special rights with regard to control of the company; (e) voting rights of shares in employee share schemes; (f) restrictions on voting rights; (g) agreements between holders of securities that are known to the company and may result in restrictions on the transfer of securities or on voting rights; (h) any rules that the company has about the appointment and replacement of directors, or the amendment of the company's articles of association; (i) significant agreements to which the company is a party that take effect alter or terminate upon a change of control of the company following a takeover bid, and the effects of any such agreements; (j) any agreements between the company and its directors or employees providing for compensation for loss of office or employment (whether through resignation, purported redundancy or otherwise) that occurs because of a takeover bid, unless disclosure of the agreement would be seriously prejudicial to the company and the company is not under any other obligation to disclose it.	✓ (Company quoted on an EU-regulated market only)	×	×	×

Regulations reference	Requirement	Quoted public company	Other public company including AIM	Large and medium-sized private company	Small private company
Sch 7.15(2), (3) & (18)	To the extent practicable for the company to obtain the information, the quantity of emissions in tonnes of carbon dioxide equivalent from activities for which that company is responsible including[35]: (a) the combustion of fuel; and (b) the operation of any facility. Also to the extent practicable for the company to obtain the information, the report must state the annual amount of emissions in tonnes of carbon dioxide equivalent resulting from the purchase of electricity, heat, steam or cooling by the company for its own use. Comparatives must be given after the first year of the application of this requirement[36].	✓	×	×	×
Sch 7.15(4)	A statement of what information in Sch 7.15(2) & (3) is not disclosed and why, if it is not practicable for the company to obtain some or all of that information.	✓	×	×	×
Sch 7.16	The methodologies used to calculate the information disclosed under Sch 7.15(2) & (3).	✓	×	×	×
Sch 7.17 & 18	At least one ratio which expresses the quoted company's annual emissions in relation to a quantifiable factor associated with the company's activities. Comparatives must be given after the first year of the application of this requirement.	✓	×	×	×

[35] Separate guidance on the application of the greenhouse gas (GHG) emissions disclosure requirements has been published by the Department for Environment Food & Rural Affairs (DEFRA): https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/206392/pb13944-env-reporting-guidance.pdf.

[36] The GHG emissions disclosure requirements are effective for the first time in periods ending on or after 30 September 2013.

Regulations reference	Requirement	Quoted public company	Other public company including AIM	Large and medium-sized private company	Small private company
Sch 7.19	The period for which the company is reporting if the period for which it is reporting the information required by Sch 7.15(2) & (3) is different to the period in respect of which the directors' report is prepared.	✓	×	×	×

This draft is issued by the Financial Reporting Council for comment. It should be noted that the draft may be modified in the light of comments received before being issued in final form.

For ease of handling, we prefer comments to be sent by e-mail to:

narrative@frc.org.uk

Comments may also be sent in hard copy to:

Deepa Raval
Financial Reporting Council
Aldwych House
71–91 Aldwych
London
WC2B 4HN

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