KPMG

Strategic Report: New guidance

2018 Guidance on the Strategic Report
Audit Committee Institute

The Financial Reporting Council's (FRC's) Guidance on the Strategic Report has been revised to address the new requirements in relation to both section 172(1) of the Companies Act 2006 and non-financial information statements. Additionally, the guidance has been refined to encourage more focused reporting, with further emphasis on those matters driving the strategic prospects of the business. The scope of the guidance has been extended to cover any company required to produce a strategic report, irrespective of listing status.

Section 172(1) statements

The requirement for the strategic report to include a 'section 172(1) statement' was introduced in July by SI2018 No.860 The Companies (Miscellaneous Reporting) Regulations 2018 and applies to large companies irrespective of listing status. (See here for our update.) The statement, effective for periods commencing 1 January 2019, must address how the directors have had regard to the matters in s172(1) in performing their duty to promote the success of the company for the benefit of shareholders as a whole. Broadly, s172(1) covers the directors' consideration of the long term consequences of decisions, matters affecting the company's employee and other stakeholder relationships, and the need to act fairly between members of the company.

The FRC's revised Guidance emphasises an 'enlightened shareholder value' approach, recognising that companies are run for the benefit of shareholders, but that the long-term success of a business is dependent on maintaining relationships with stakeholders and hence the external impact of the company's activities. Companies should therefore be applying the same focus and approach to materiality in this statement as they do for the rest of the strategic report.

The Guidance is non-prescriptive, but it is expected that statements will, as a minimum, cover:

— **Relevant matters:** The issues, factors and stakeholders the directors consider relevant in complying with section 172(1) and how they have formed that opinion – i.e. the relationships that drive long-term business success.

— **Engagement:** The main methods by which the directors have engaged with stakeholders with a view to understanding the relevant issues.

— **Decision making:** Information on the effect of that regard on the company's decisions and strategies during the financial year. This is likely to include those decisions where the board has needed to balance the competing needs of different stakeholders; the role of culture as a basis for decision making within the business; and, financial capital allocation decisions, including in relation to dividend policy.

Companies should already be covering the longer term aspects of their strategy and performance in their strategic reports, but may benefit from a more formalised process to track these activities ahead of the start of the first reporting period.

Some additional considerations may be relevant for unlisted companies covered by the s172(1) requirement:

— Subsidiary companies required to prepare a s172(1) statement cannot assume that the matters covered in their parent company's statement are the same as those that apply to the subsidiary.

— Companies that do not publish their annual report on a web site nevertheless have a statutory obligation to publish their s172(1) statement.

Non-Financial Information Statement

The Guidance updates and finalises draft changes issued to support the non-financial reporting regulations (applicable to public interest entities for periods beginning 1 January 2017). The FRC has sought to address key concerns highlighted in the first year of implementation. In particular:

— **Focus:** The Guidance emphasises the disclosure of non-financial information that is necessary for an understanding of the development, performance, and position and the impact of a company's activity. This is particularly relevant to the discussion of business impacts which should be considered in the context of their effect on the company's ability to generate and preserve value over the longer term.

— **Scope:** There is a reminder that non-financial information should not be limited to the list of *de minimis* areas contained in the Companies Act. Companies need to consider all of the resources and relationships which are necessary for an understanding of the development, performance or position of their business. This will typically include customers, suppliers, intellectual property, and in some cases, the company's pension scheme.

— **Form:** The Guidance clarifies that the Non-Financial Information Statement must be a discrete part of the strategic report. A 'contents page' approach that cross-references to the rest of the strategic report is recommended in order to meet the requirement without disrupting the narrative flow of the overall report.

Supporting more focused strategic reports

Guidance has been updated and enhanced to support a longer term perspective on companies' strategy and performance. None of these changes should be new to those following the spirit of the original guidance, but they may serve as a reminder for aspects of the strategic report that require additional attention:

— **Materiality:** A two-step approach to materiality is set out. Boards should consider first the matters that are genuinely material to business prospects, and then determine the material disclosures required to support this. The approach should foster deeper, more relevant disclosure on the key issues affecting the business's sustainable prospects, whilst reducing less value-relevant disclosures.

— **Business model:** The description of the business model should focus on the aspects most important to an understanding of the generation and preservation of value. The role of the business model description in providing context for the rest of the report is also emphasised.

This addition reflects recent Financial Reporting Lab comments that trends in business model reporting have led to 'some of the detail behind what the company does and how it is generates value being missed'. To meet this challenge, descriptions will need to provide sufficient granularity to enable readers to assess the implications of matters raised across the report. For example, if the business strategy involves expansion in a particular region, readers will look to the business model to understand any differences in business operations how the business operates in that region compared to elsewhere.

— **Risk identification:** Systemic risks are identified explicitly as an area for consideration that could have a material effect on the entity's long term prospects

— **Performance reporting:** Measures presented should support an assessment of the entity's progress against its strategy and objectives. Whilst the breadth of measures being reported has grown in recent years, providing the right measures has continued to be a challenge for many. KPMG's research identifies areas where measures being reported could align better with business success factors.

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