# The section 172 statement

KPMG Better Business Reporting

Strategic Reports must include a 'section 172' statement for periods commencing on or after 1 January 2019. The statement must explain how the directors have had regard to the 'enlightened shareholder value' requirements of s172 in performing their duties. All large companies, including subsidiaries must make the statement.

**Directors' section 172 statement**

Section172 deals with the directors' duty to promote the success of the company for the benefit of shareholders as a whole, having regard to a number of broader matters including the likely consequence of decisions for the long term, the need to act fairly between members of the company, and the company's wider relationships. The approach required is sometimes referred to as 'enlightened shareholder value'.

For periods commencing 1 January 2019, the strategic report must include a statement explaining how the directors have had regard to the matters in s172 in performing their duties. The requirement applies to large companies - including subsidiaries - irrespective of listing status.

Whilst there is no set structure for the statement, guidance on what may need to be included to meet the Companies Act requirement is available in the FRC's Guidance on the Strategic Report. This note looks at the practical considerations in applying the guidance to address each component of s172. It covers:

- How to approach the statement
- The role of culture in the statement
- Consideration of long-term factors
- Stakeholder considerations
- The need to act fairly between members
- Other practical considerations

Statements are likely to have a high profile as public concern over perceived short-term corporate behaviour continues, with focus on the directors' consideration of the funding required to meet pension commitments and long term investment needs. The FRC has statutory powers to investigate whether a company's statement complies with the Act.

**In summary - s172 Statement**

- A discrete, factual statement in the strategic report, describing how the directors have performed their s172 duties over the period.
- The statement should focus on matters material to shareholders, including the director's consideration of:
  - long term factors affecting the company;
  - the company's wider relationships (for example, customer, supplier, employee, society)
  - the need to act fairly between members as a whole
- FRC Guidance anticipates statements will cover three broad areas:
  1. Identify the issues, factors, and stakeholders considered relevant
  2. Describe how the directors have ensured they understand the issues (for example by stakeholder engagement)
  3. Explain how the directors' principal decisions have had regard to this
- Statements may typically be built around references to other content in the strategic report (particularly, business model, strategy, culture, and governance). The quality of these existing disclosures should be reviewed.

## Approaching the statement

Whilst there is a significant stakeholder component to the s172 statement, it should not be confused with social responsibility reporting. Reflecting the section 172 duty itself, the focus of the statement should be on how the directors have promoted the success of the company for the benefit of shareholders as a whole.

In applying the guidance, the same focus and approach to materiality is required as for the rest of the strategic report. That should mean statements focus on the small number of strategically important issues that the future success of the business rests on.

Companies should already have much of the required content in their strategic reports. In general:

- Business model descriptions should already be identifying and explaining the key relationships that the business depends on
- Principal risk disclosures should be identifying threats to those relationships that could disrupt the long term success of the company
- Impact reporting (introduced in 2017) should be addressing business impacts that potentially affect these relationships
- Strategy discussions should be addressing the long-term direction of the business

These are all areas where challenges have been raised over the quality of corporate disclosure. So, a first step should be to review the quality of existing disclosures, close any gaps, and decide how best to reference the improved disclosures from the statement.

Companies are also likely to find significant overlap with the new 'part 4' directors report disclosure requirements on employee and other stakeholder engagement (see panel at the end of this note). That information must be provided irrespective of materiality. Where material it may instead be included in the strategic report.

## Culture is an underlying theme

Maintaining an effective culture is not an explicit s172 requirement, but doing so will typically be a key component in addressing it.

Culture can be particularly important in giving the board confidence that day-to-day corporate decisions are being approached with an appropriate mind-set. It will generally be appropriate for the s172 statement to address (or more likely, reference) descriptions of the company's desired culture, how the directors monitor it and how they support its achievement. Actions taken to address any issues arising during the period should generally also be described.

Question to consider:

- Does the s172 statement address culture?

## Consideration of long-term factors

Section 172(a) deals with the directors' responsibility to consider the likely consequences of decisions for the long term. To address this, the statement will generally need to set out the company's long-term strategy and explain how directors' decision-making has supported the implementation of that strategy.

Companies will need to identify their strategic priorities, and describe how their plans support their achievement. The final step should be to explain how the key decisions taken during the year support this.

This should already be a focus for the strategic report, though concerns continue to be raised over the extent to which companies' strategy discussions do in fact address the long-term. An effective long-term discussion will typically link the company's shorter-term operational decisions to the core purpose that drives the companies overall direction.

Questions to consider:

- Does the s172 statement link to the discussion of strategy? Is this description genuinely long term?
- Does it explain how the director's shorter-term decisions align with the company's long-term purpose?
- Does it explain how the directors considered emerging trends, including feedback from customers and other stakeholders in setting and reviewing strategy?

The consideration of long-term factors is also likely to be an important aspect of setting the company's dividend and distribution policy – an area of major emphasis in the FRC's guidance. Interest in the directors' consideration of distribution policy is linked to the wider debate on capital maintenance in UK company law.

Where applicable, the statement should describe how the directors have determined that the distribution policy leaves the company with sufficient resources to support its long-term success. Consideration of the factors underlying the directors' viability assessment is likely to be an important component. Other factors may also have been considered, including the levels of investment required to deliver the company's long-term strategy, and the future availability of funds required to meet longer-term obligations such as pensions.

Question to consider:

- Does the s172 statement explain distribution decisions by reference to the factors considered in the directors' viability assessment, the resources required to support the company's long-term strategy, and the consideration of other long term obligations? Is the rationale for retaining funds to support future investment explained?

### Stakeholder considerations

Section 172(b)-(e) deals with consideration of stakeholder relations, the environment, and reputation. The statement requires a focused approach to disclosure to meet its shareholder-focused objective. It should be addressing those specific matters that affect the success of the company, rather than providing a generalised discussion.

Companies providing a non-financial information statement will already be addressing these areas, so may focus on checking the adequacy of these disclosures and referencing them in the s172 statement.

Questions to consider:

- Does the business model discussion identify the key relationships that the success of the company depends on? Does the statement describe how the company has assessed their perspectives (for example customer feedback) and monitored its impact on them?
- Does the strategic report identify the company's impacts on the environment that could in turn affect the future success of the company. Does it explain how these are monitored?
- Does the strategic report describe the company's ethics and values that underpin its reputation, and explain how these are monitored
- For each of the above areas:
  - does the strategic report explain how the directors take the above issues into account, including actions taken to monitor and mitigate risks?
  - does the s172 statement link to the parts of the strategic report containing the material related information?

It may be the case that interests of key stakeholder groups do not align with each other or the long-term success of the company. The directors' approach to any related decisions may need explaining.

Questions to consider:

- If major strategic decisions have been taken during the period (such as restructurings or M&A), does the statement explain how the directors approached those decisions?
- Does the statement explain how the directors assessed and mitigated the different stakeholder impacts in determining the appropriate course of action.

### The need to act fairly between members

Section 172(f) deals with the need to act fairly between members of the company. The extent to which information is required here will depend on the specific circumstances of the company. The disclosure is most likely to be relevant to joint ventures and associates, and those companies with multiple classes of shares (for example, private-equity owned), minority or dissenting shareholder groups.

### Other considerations

Parent and subsidiary company statements

The s172 statement is made at a company, not a group level. However, a parent company's success will depend on the success of its subsidiaries, and therefore it will generally be appropriate to address matters as they relate to its group (or sub-group) as a whole.

Subsidiary companies required to prepare a statement cannot simply refer to their parent's statement. Whilst many of the policies and procedures followed may be the same, the subsidiary directors' duty is owed to the company, not the parent. However, guidance indicates that subsidiaries may cross-refer to relevant content in the parent's statement[1].

Seriously prejudicial disclosures

In general, information about impending developments or matters in the course of negotiation may be omitted from the strategic report if the disclosure would, in the opinion of the directors, be seriously prejudicial to the interests of the company. However, FRC guidance confirms that there is no such exemption for s172 statement disclosures.

Publishing the statement

Companies are required to publish their s172 statement on a web site maintained by or on behalf of the company as soon as reasonably practicable[2]. Most companies are likely to achieve this by publishing their annual report on the group's website. Those that do not will need to publish the statement separately.

Auditors' responsibilities

Whilst the s172 statement is not audited, auditors are required to report any material misstatements (including omissions) that they become aware of during the course of their audit. Early discussion of a draft statement is advisable.

[1]Department for Business, Energy & Industrial Strategy: The Companies (Miscellaneous Reporting) Regulations 2018 – Q&A
[2]Required by Companies Act s426B

## Companies Act requirements

### Part 4 Directors report requirements: Engagement with employees, suppliers, customers and others

The directors report must (subject to certain exemptions) include a statement on engagement with employees:

a) describing the action that has been taken during the financial year to introduce, maintain or develop arrangements aimed at—
   - i. providing employees systematically with information on matters of concern to them as employees,
   - ii. 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,
   - iii. encouraging the involvement of employees in the company's performance through an employees' share scheme or by some other means, and
   - iv. achieving a common awareness on the part of all employees of the financial and economic factors affecting the performance of the company, and

b) summarising—
   - i. how the directors have engaged with employees, and
   - ii. how the directors have had regard to employee interests, and the effect of that regard, including on the principal decisions taken by the company during the financial year.

The directors report must (subject to certain exemptions) include a statement on engagement with suppliers, customers and others in a business relationship with the company that:

— summarises how the directors have had regard to the need to foster the company's business relationships with suppliers, customers and others, and the effect of that regard, including on the principal decisions taken by the company during the financial year.

### Section 172 reporting (s414CZA)

1) A strategic report for a financial year of a company must include a statement (a "section 172(1) statement") which describes how the directors have had regard to the matters set out in section 172(1)(a) to (f) when performing their duty under section 172.
2) Subsection (1) does not apply if the company qualifies as medium-sized in relation to that financial year (see sections 465 to 467).

### Directors' section 172 obligations

A director of a company must 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.

Guidance on directors' section 172 obligations is available in the GC100 publication: Guidance on Directors' Duties Section 172 and Stakeholder Considerations (October 2018)

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