



26 November 2013

Our ref: ICAEW Rep 167/13

Your ref:

Deepa Raval,
Financial Reporting Council,
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Dear Deepa,

Exposure Draft: Guidance on the Strategic Report

ICAEW is pleased to respond to your request for comments on the FRC consultation paper, *Guidance on the Strategic Report*.

Please contact me or Nigel should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW REPRESENTATION

GUIDANCE ON THE STRATEGIC REPORT

Memorandum of comment submitted in November 2013 by ICAEW, in response to the FRC exposure draft *Guidance on the Strategic Report*, published in August 2013.

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the exposure draft *Guidance on the Strategic Report*, published by the Financial Reporting Council in August 2013, a copy of which is available from this [link](#).

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the FRC. We provide leadership and practical support to over 140,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.
3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.
4. The Financial Reporting Faculty is recognised internationally as a leading authority on financial reporting. The Faculty's Financial Reporting Committee is responsible for formulating ICAEW policy on financial reporting issues, and makes submissions to standard setters and other external bodies. The faculty also provides an extensive range of services to its members, providing practical assistance in dealing with common financial reporting problems.

MAJOR POINTS

Support for the initiative

5. We support the FRC's work to promote high quality narrative reporting. We believe that the quality of UK narrative reporting has increased considerably in recent years and that the provision of clear guidance in this area has contributed to this positive progress. Therefore, with the recent approval of new narrative reporting regulations, effective for financial years ending on or after 30 September 2013, we agree that there is now an urgent need for guidance which not only enables companies to comply with the regulations but also promotes more effective communication with shareholders. However, there are some specific areas where we believe that refinements to the draft guidance could be made. These are explored further below.

Guidance for unquoted companies

6. The draft guidance has been written with quoted companies in mind, although it is also intended to be useful for other entities preparing strategic reports. However, as the strategic report of a large or medium-sized unquoted company (small companies are exempt) is subject to fewer legal requirements than a quoted company, much of the guidance will simply not be applicable. This is most obvious in section six, which outlines the content elements of the strategic report. Indeed, of the nine content elements outlined, only three would be relevant to a private company.
7. We believe that, in order to improve narrative reporting across the board, it is essential that the guidance aimed at quoted and unquoted companies is very clearly differentiated, adopting a "think small first" approach (although of course the smallest companies producing strategic reports will be medium-sized). We recommend that the FRC consider providing a separate and shorter guidance document aimed specifically at unquoted companies. Alternatively, it may be useful to indicate early on within the guidance which requirements are relevant to unquoted companies. In this case, it would also be necessary to consider the structure of the guidance to

ensure that unquoted companies can easily identify the relevant areas and that the order and flow of information is still clear.

Structure, style and length of the guidance

8. The guidance should be easy to follow, with a logical order of information, and should clearly distinguish between the regulatory requirements and the non-mandatory guidance provided by the FRC. On this basis, we believe that there are several areas where the structure of the document could be improved.
9. The overarching purpose of the guidance is to promote effective communication between a company and its shareholders. Therefore, we recommend that the section on communication principles appears at the beginning of the guidance to ensure that subsequent sections on placement, content and materiality are considered within the context of these core principles. In addition, we strongly recommend that care is taken with the terminology used for these communication principles. The first principle states that the strategic report should be 'fair, balanced and understandable', which appears to be taken from the UK Corporate Governance Code (the Code). However, this does not entirely match the requirements of the legislation which refers to fair and balanced but does not make reference to the term understandable. Furthermore, the legislation also includes a requirement for the strategic report to be comprehensive. There is a risk that presenting the communication principles in this way will result in confusion and make it difficult for companies to clearly distinguish between what is mandatory and non-mandatory. The guidance should thus draw out the distinction between the requirements of the law, the 'comply or explain' of the Code and what is recommended as best practice.
10. Furthermore, the decision to enlarge the wording used to describe the content elements of the strategic report also makes it difficult to distinguish between the regulatory requirements and the corresponding guidance. We recommend that the FRC reviews this section to ensure that the content elements are consistent with the wording used in the regulations. Any embellishment of these requirements which is considered necessary should be clearly identified as non-mandatory guidance.
11. There are some instances of repetition within the document, and several sections, in our opinion, do not appear to add any real value to the overall guidance. In particular, we would place section 4, section 6.4 and the diagram included in paragraph 6.29 in this category. We recommend that these sections do not appear in the final guidance.

Placement of information

12. We welcome the inclusion of guidance on the placement of information in the annual report. This will be a key issue for companies seeking to communicate with shareholders in an effective and innovative way whilst continuing to comply with company law and regulatory requirements. However, we believe that the descriptions given to 'core' and 'supplementary' are too ambiguous and require further clarification. For example, supplementary may be taken to mean information which is not material. However, such a definition would cast doubt over whether this type of information should, unless required by regulations, even have a place in the annual report. An alternative interpretation may be that supplementary means extra information which enables users of the annual report to drill down further into the core information already provided in the strategic report. We recognise that this raises the question of whether there is a clear boundary to the strategic report.
13. In this context it would be helpful to acknowledge that many companies are driven by the safe harbour available under s463 CA 2006 to ensure that all information (other than the audited financial statements) is somehow 'placed' either directly or by cross reference into one of the three statutory reports that have the safe harbour. This leads on to questions of the extent to which it is legally permissible to split the strategic report (and the directors' report) and the use

of cross-referencing between reports. The FRC would be helping all companies by giving a view (presumably in conjunction with BIS) on how much flexibility is available for companies to take a more relaxed, innovative and holistic approach to their reporting, while remaining within the law.

Strategic report with supplementary information in place of summary reports

14. The option to provide summary financial statements in place of the annual report to shareholders has now been replaced with the option to provide the strategic report with supplementary information. We believe that it would be helpful for the FRC to confirm in the guidance that it is necessary under the law for the strategic report as presented in the annual report to be the same as that presented as a standalone document.
15. Where this option is taken advantage of, the strategic report would be viewed in isolation, outside the context of the annual report as a whole. This is not compatible with the objective of improving cohesiveness and linkages in corporate reporting. For example, a strategic report which links to various sections may appear incomplete or confusing when viewed outside the annual report. Indeed, it may be considered by many that the strategic report prepared in this way is not fit for purpose as a standalone document.
16. We are aware that companies are considering different approaches to dealing with this issue. One option is to make the strategic report capable of being an entirely standalone document by including summary information on financial statements, governance, directors' pay and so on, which will by definition lead to repetition and clutter within the annual report. Another is to add further voluntary information to the strategic report as it appears in the annual report. We are also aware that some companies are considering taking an entirely non-statutory route to give retail shareholders in particular a more accessible document (along with the annual report and accounts). We recommend that the FRC includes additional guidance for companies taking this option.

RESPONSES TO SPECIFIC QUESTIONS/POINTS

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?

17. We understand that the FRC has prepared Illustration 1 to help preparers make judgements regarding where information would be best located in the annual report. It is not intended to impose a specific structure on the annual report nor serve as a comprehensive example. Whilst we have some sympathy with these aims, we have several reservations over the illustration in its current format.
18. We are unsure if the illustration will add value to those using this guidance. It largely illustrates the sections as required by regulations that feed into an annual report. This may be beneficial to companies preparing an annual report for the first time and seeking guidance on compliance. However, companies with experience in preparing annual reports may place greater value on an illustration that demonstrates ways in which they may consider developing their own approach to preparing the annual report.
19. We believe that users of the guidance will naturally look to the illustration as a guide to how to structure their annual report, regardless of the fact that this is not the intention of the FRC. Therefore careful consideration should be given to whether the content and structure of the illustration supports and is consistent with the overall objectives of the guidance, particularly the innovation and cohesiveness of the information included in the annual report.

20. Currently, the tabular format of Illustration 1 divides each section of the annual report into a separate box. In our opinion this does not support the fundamental principles outlined in the guidance. We recommend that FRC considers an alternative format which more appropriately illustrates flexibility, linkages of information, and a holistic approach to preparing the annual report. One option may be to use circles (representing different areas of the annual report) arranged in a non-uniform way, demonstrating possible linkages.
21. The illustration only includes details of those sections required by company law or other regulations. As a result, sections which commonly appear in a company's annual report, though not a regulatory requirement, are excluded, for example, the Corporate and Social Responsibility information and the Chairman's Statement. However, we note that paragraph 3.3(b) states that '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 balance and understandable.' Later, in paragraph 3.12, the draft guidance states that other detailed information could be presented in the 'appendices to the annual report or, where company law or other regulation allows it, in a separate document or online.' A final example is paragraph 6.66 which, when referring to environmental, employee, social, community and human rights issues, states that 'if the directors consider that this type of information is important but not material...(it) could be located elsewhere, for example, in a sustainability report.' In addition, the illustration excludes the auditor's report, which forms an important part of the overall structure of a company's annual report. There appears to be a mismatch between the objective of the illustration which, as noted above, is to assist preparers 'make judgements regarding where information would be best located in the annual report', the information included in the illustration and the guidance provided elsewhere in the document.
22. Whilst we believe that an alternative illustration should be considered, this must be balanced against the need for the timely release of the final guidance. Therefore, we recommend that the final guidance is released without any illustrations. Instead, this matter should be considered further by FRC (perhaps through the Financial Reporting Lab) and if appropriate released as a separate document to supplement the guidance at a later date, which would perhaps help to avoid any examples being used as templates (and hence boilerplate) by companies.

Question 2

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

23. The illustration provides objectives for each component and each section of the annual report. We broadly support the objectives given to each area but note that there is some inconsistency in the wording used. For example, one objective of the narrative reports is 'to complement, supplement and provide context for the related statements' whereas the associated objective for the strategic report is more simply described as 'to provide context for the related financial statements.' We recommend that the FRC reviews the objectives and ensures appropriate consistency to avoid any confusion.

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?

24. We welcome the inclusion of guidance on the placement of information in the annual report. This will be a key issue for companies seeking to communicate with shareholders in an effective and innovative way whilst continuing to ensure compliance with company law and regulatory requirements. FRC has proposed a 'core and supplementary' approach where core information is described as 'the most important information' and supplementary information is

described as ‘other detailed information.’ The core information would be given prominence, usually in the strategic report whilst other detailed information would be placed elsewhere, either in the appendices of the annual report, or where permitted, in a separate document or online.

25. In our opinion, the descriptions given for core and supplementary are ambiguous and we would welcome further clarification on this point, including what is legally permissible. For example, supplementary may be taken to mean information which is not material. However, such a definition would cast doubt over whether this type of information should, unless required by regulations, even have a place in the annual report. An alternative interpretation may be that supplementary means extra information which enables users of the annual report to drill down further into the core information already provided in the strategic report. We recognise that this raises another question on whether there is a clear boundary to the strategic report and whether its contents can in fact be split up to aid the narrative flow.
26. In this context it would be helpful to acknowledge that many companies are driven by the safe harbour available under s463 CA 2006 to ensure that all information (other than the audited financial statements) is somehow ‘placed’ either directly or by cross reference into one of the three statutory reports that have the safe harbour. This leads on to questions of the extent to which it is legally permissible to split the strategic report (and the directors' report) and the use of cross-referencing between reports. The FRC would be helping all companies by giving a view (presumably in conjunction with BIS) on how much flexibility is available for companies to take a more relaxed, innovative and holistic approach to their reporting, while remaining within the law.

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?

27. We agree that the concept of materiality when applied to the strategic report should be consistent with the definition of materiality used in International Financial Reporting Standards. However, it may be useful for the guidance to clarify what is meant by ‘relevant to shareholders’ needs’ to assist companies in assessing what information to include in the strategic report. It would also be helpful for the guidance to note which requirements of the strategic report are not subject to some kind of materiality filter (for example gender reporting).
28. The section on materiality also includes a brief summary of the provision within the regulations that enables directors to refrain from disclosing information on impending developments or matters in the course of negotiation which would, if disclosed, be seriously prejudicial to the interests of the company. In our opinion this is an area which in itself is likely to attract a degree of uncertainty. Whilst it may be difficult to provide specific guidance in this area due to the fact that matters considered seriously prejudicial are likely to be highly company-specific, it may be appropriate to provide some general guidance to assist boards when considering this provision in the regulations.

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?

29. We agree that the inclusion of the communication principles will be useful for preparers of the strategic report. Indeed, the overarching purpose of this guidance is to promote effective

communication between a company and its shareholders. Therefore we recommend that this section appears at the beginning of the guidance to ensure that subsequent sections on placement, content and materiality are considered within the context of these core principles. Aside from the location of the section we have several concerns, which are discussed below.

30. The first principle states that the strategic report should be fair, balanced and understandable. This appears, from the references given in the guidance, to be taken from the UK Corporate Governance Code (the Code). However, this does not entirely match the requirements of the legislation (which does refer to fair and balanced, but not to understandable). The legislation also includes a requirement for the strategic report to be comprehensive which, as set out below, does not match the formulation in the Code.
 - *SI 2013/1970 - 414C (Contents of the Strategic Report)*
 - (2) The strategic report must contain:
 - A fair review of the company's business, and
 - A description of the principal risks and uncertainties facing the company.
 - (3) The review requires 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.
 - *Corporate Governance Code – Code Provision C1.1*
 The directors should explain in the annual report their responsibility for preparing the annual report and accounts, and state that they consider the annual report and accounts, 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. There should be a statement by the auditor about their reporting responsibilities.
31. We believe that using the text from the Code, applicable to the annual report and accounts as a whole, may not be entirely appropriate in this context to form a communication principle specific to the strategic report as it may result in some confusion. There is also again a risk that companies will not be able to clearly distinguish from the guidance what is mandatory and non-mandatory when preparing the strategic report.
32. The second principle (paragraph 6.11) states that the strategic report should be concise. It may be appropriate to clarify how this can be best achieved whilst also ensuring that the review, as required by the regulations, is comprehensive. Although this is briefly considered in paragraph 6.15, we believe that it would be beneficial to provide some clear commentary on the meaning of comprehensive in this context. As it stands, the text appears contradictory.
33. The third principle (paragraph 6.16) states that, where appropriate, information in the strategic report should have a forward-looking orientation. However, there is limited guidance on how a company might achieve an appropriate balance between details of their past performance and position and details of any factors likely to impact on the future performance, development and position of the business. We believe that there is scope to expand the guidance usefully in this area to ensure that companies do not focus too heavily on a particular timeframe at the expense of another.
34. The sixth principle (paragraph 6.26) states that '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.' In our opinion, this is not a communication principle and does not add value to those responsible for preparation of the strategic report. We recommend that this point is downgraded from a key principle to a general point outlining how the annual report is expected to evolve over time. In addition, the supporting text to this principle describes how

any changes to the structure or presentation of the strategic should be considered in terms of the quality of information provided. It may however be sensible to balance this against the need for a reasonable degree of consistency in the reporting to discourage changes which reduce the accessibility and understanding of the strategic report.

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?

35. Please see our comments on question 5.

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?

36. We agree that the guidance should include the content requirements as set out in the Act. However, the current structure of this section and the decision to expand on the wording of the requirements makes it difficult to distinguish between the mandatory requirements and non-mandatory guidance. In our opinion it is vitally important that this distinction should be abundantly clear to the user. This may particularly be the case for unquoted companies, which are subject to fewer narrative reporting requirements than quoted companies and may therefore wish to pinpoint the applicable regulatory requirements and associated guidance.
37. The structure of this section presents each content requirement in bold with any guidance included underneath. However, in some cases the text in bold enlarges on the wording used in the regulations. For example, paragraph 6.31 states that a 'strategic report should include a description of the entity's principal objectives and its strategies for achieving those objectives' whereas the regulations refer only to a description of the company's strategy. Also, the requirement in relation to risk gives the impression that it is mandatory to include information on management and mitigation of those risks, when it is in fact not a legal requirement to do so. Wording the content element on risk in this way appears to reflect the FRC views on this matter rather than being in line with the requirements of the regulations. This is not helpful. We recommend that the content requirements are consistent with the wording of the regulations. Any embellishment of these requirements considered necessary for understandability, or to reflect regulatory views, should be identified clearly as non-mandatory guidance.

Human rights

38. There is limited guidance on how quoted companies should approach the reporting of human rights issues within the strategic report. However, as this is a new requirement, there is a particular need for guidance in this area. It would for example be useful to provide some suggestions of the types of activity which may affect human rights and should therefore be considered by companies when reporting on human rights issues.

Future developments

39. The draft guidance states that the description of an entity's strategies should allow shareholders to predict future developments in the business (paragraph 6.35). This is likely to be very challenging (if not impossible) given directors are not in a position to predict all future developments. It appears moreover to be inconsistent with guidance presented elsewhere, in particular the 'forward-looking' orientation communication principle (paragraphs 6.16 to 6.18),

which notes more modestly that information should be included that is relevant to ‘an assessment of future prospects’. It is important that there is a consistent and clear message throughout the guidance. It is not helpful for the user of the guidance if the same principle is repeated in different ways at various points. The descriptions and definitions given to key principles must be consistent with and supported by the guidance in other sections.

KPIs

40. Paragraphs 6.57 to 6.58 outline the information required to enable shareholders to understand the KPIs included within the strategic report. We recommend that this section also mentions the use of any targets previously set for KPIs. This can be an effective way for a company to demonstrate and comment on its performance during the period.

Gender diversity

41. The new requirement to disclose information on gender diversity is likely to be an area that many companies find challenging. In our view the guidance provided does not really address some of the practical issues that have arisen to date. For example, as the test in s 414C (10)(b) relates to the directors of companies included in the consolidation, does that mean that if a company is excluded from consolidation (eg, on grounds of materiality), those directors are not included in the figure, although presumably if they met the test in subsection (9)(a) in a group context they would be included? Also, senior managers who are not employees would not be included according to the test in subsection (9)(b).
42. We understand that a potential concern for a number of companies is that the requirement in s 414C (10)(b) fails to recognise that the directors of subsidiaries are frequently not senior managers in a group context because of the way groups are structured for management purposes. Some companies may decide, in addition to the legal disclosure (which may as a result of the law be meaningless in terms of the objective of the disclosure), to add voluntary disclosures that show their real senior executive pipeline in a group context. This is not ideal.

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?

43. We agree that the definition of a business model should be consistent with the Code. We note that the concept of the business model has only recently come to the fore in financial reporting, and that there is currently no single accepted view on how best to describe and report the business model or models. The introduction of an additional definition solely for the purpose of preparing the strategic report would add an unnecessary layer of complexity at a time when some companies are already uncertain about what constitutes good practice in this area. Over time it may be useful for the FRC to consider providing a small number of examples of business models, or questions which companies may choose to consider when identifying and describing their business model, perhaps through the work of its Financial Reporting Lab.
44. With this need for consistency in mind, we note moreover that the definition of a business model in the glossary is not always in line with descriptions outlined elsewhere in the guidance. In particular, the glossary defines the business model as ‘how the entity generates or preserves value over the longer term’ whilst the illustration in paragraph 6.29 simply defines the business model as ‘what the business does.’ Paragraph 6.30 expands on this by stating that an entity will ‘apply its business model to its activities in pursuit of its objectives and strategies.’
45. There also appears to be an almost exact repetition of the wording used in paragraphs 6.38 and 6.40. However, whilst the former states that the company should describe how the company generates, preserves and captures value, the latter states that a company should set

out the most important parts of the business that generate, preserve or capture value. Whilst the definitions and descriptions appear to overlap, the inconsistencies and subtle differences may make it harder for companies to identify clearly and describe their business models. We recommend that the description and definition of the business model is consistent throughout the guidance.

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?

46. We believe that objectives and strategy are clearly described in the guidance. However, as noted above we recommend that FRC ensures that the definitions used for these terms are consistent throughout the guidance.
47. We are not clear about the purpose of the diagram in paragraph 6.29, which briefly defines the objectives, strategy and business model of a company. The diagram does not appear to belong to the text within this paragraph nor is it consistent with the following paragraph 6.30. In our opinion the diagram adds limited value and we recommend that it does not appear in the final guidance.

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?

48. The inclusion of examples can be an effective way to put guidance in context. However, in our opinion the examples included in the guidance are very high level and may be of limited help to preparers of the strategic report. Over time, it may be useful for the FRC (perhaps through the Financial Reporting Lab) to produce more detailed examples demonstrating how information can appropriately be linked within the annual report as a whole.

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