Non-Financial Reporting: The Future of the Strategic Report?

Reporting for the 21st Century

Reporting by companies is evolving into a model suitable for the 21st Century. The time when a company produced a set of numbers in their annual report and accounts with little or no commentary and a brief directors’ report has long since passed. Driven by financial crises, company collapses, corporate scandals and pressure groups, legislation and regulations have, over time, been introduced to require comprehensive non-financial reporting to enable investors and the wider community to assess a company’s prospects with greater certainty. However, there is a call for further improvement over traditional reporting models as regulations have added to the complexity of reporting but have not necessarily produced clarity. This briefing considers some of the trends and non-financial reporting initiatives that are influencing reporting which companies ignore at their peril if they wish to continue to meet investor expectations.

Background - The Strategic Report

The Companies Act 2006 (CA 2006) introduced the requirement to prepare a strategic report and came into effect for financial years ending on or after 30 September 2013. The strategic report has a specific statutory purpose which is ‘to inform members of the company and help them assess how the directors have performed their duty under section 172 of the CA 2006’. This is the duty of a director to act in the way that would be most likely to promote the success of the company for the benefit of members as a whole. Section 172 sets out matters that the directors must have regard to when performing this duty. These include the likely consequences of any decision in the long term, interests of company employees and impact on the community and environment. This means that companies need to consider these matters in their reporting and gives a clear steer of the expected audience and content of the strategic report.

The strategic report is currently the key non-financial reporting vehicle for a business to explain its purpose, strategy and business model with a requirement to address both positive and negative issues in order to present a fair and balanced picture. However, other growing influences are and will continue to shape in particular the content of non-financial reporting. Some of these are considered below.

EU Directive on Non-Financial Reporting

Regulation coming out of the European Union is further developing the importance of non-financial reporting. In December 2014 the EU introduced a directive requiring disclosure of non-financial and diversity information by certain large companies. The regulations are due to be implemented in the UK by 6 December 2016 and will apply to financial years starting on or after 1 January 2017. The requirements apply to Public Interest Entities (for example listed companies) with an average of more than 500 employees and which meet the large company size definition in the Companies Act 2006.
Many of the provisions in the Directive reflect those that are already required for the strategic report content although there are some differences. For example, as well as information relating to environmental, social and employee matters and human rights, information about anti-corruption and bribery matters is required. Relevant policies and their outcomes and the main risks arising from environmental, social, employee matters, human rights and anti-corruption will be required and reporting on non-financial KPIs. It should be noted that, in the strategic report, reporting is required only ‘to the extent necessary for the understanding of the development, performance or position of the company’s business’. The Directive requires disclosures when they are ‘necessary for an understanding of the impact of the entity’s activity’. The non-financial principal risks identified in relation to these matters will need to include those linked to a company’s ‘business relationships, products or services which are likely to cause an adverse impact in these areas’. In addition there is now an explicit requirement to describe how these non-financial risks are managed. If a company does not have policies in these areas the company must set out a ‘clear and reasoned explanation’ for not having a policy.

The Department for Business, Energy and Industrial Strategy (BEIS) has carried out a consultation on various options that can be implemented under the Directive. This includes whether the non-financial policy statement should be independently verified and whether companies should be able to publish their non-financial statements solely on a website.

The Growing Importance of Integrated Reporting

The concept of integrated reporting has been around for some years. Its adoption in the UK has been slow but has been more widely taken up in other countries. It has, however, helped influence companies in the UK in their thought processes and style when producing strategic and governance reports.

Integrated reporting was established by the International Integrated Reporting Council (IIRC) which is a global coalition of regulators, investors, companies, accounting profession and NGOs set up to promote communication about value creation. The aim of the IIRC is to ‘align capital allocation and corporate behaviour to wider goals of financial stability and sustainable development through the cycle of integrated reporting and thinking’. The method promoted to do this is the International Framework published in 2013 which provides guidance on producing an integrated report that is centred on seven guiding principles: strategic focus and future orientation, connectivity of information, stakeholder relationships, materiality, conciseness, reliability and completeness, consistency and comparability.

The content elements, which are designed to place stakeholder needs at the centre of reporting, include an organisational overview and external environment, governance, business model, risks and opportunities, strategy and resource allocation, performance, outlook and basis of presentation. These elements are supported by a series of questions which encourages adaption of the framework to individual company needs. The similarities between the framework and the strategic report content can be seen and the FRC has acknowledged that it was mindful of integrated reporting developments when it prepared its guidance on the strategic report.
The Financial Reporting Council perspective

The Financial Reporting Council (FRC) is a key and important body influencing the development of non-financial reporting. The FRC produce guidance for companies on preparing the strategic report with a view to improving reporting in general, which although aimed at quoted companies, provides a best practice standard. The FRC publish an annual review of reporting which examines the progress of reporting and gives examples of best practice. They also seek to influence current thinking by producing a number of discussion papers such as that on ‘cutting the clutter’, dividend and tax reporting. The FRC Reporting Lab published its report on Business Model Reporting in October 2016.

Investor perspectives

There are also indications that non-financial reporting is growing in importance to investors. This is reflected in initiatives such as that launched by the Investment Association at the end of 2015 which focuses on long-term value brought by people to business. This seeks to encourage and support human capital reporting. Improving reporting on culture and human capital and accounting for intangibles also forms part of the Investment Association’s ‘Productivity Action Plan’ which makes twelve recommendations for improving productivity. Other publications, for example Beyond the numbers: A guide to better corporate reports published by Legal & General Investment Management, provide further evidence of the importance of these types of issues and approaches to investors themselves.

Prism perspective

It is clear that the time when businesses could just present a set of numbers to its stakeholders is long since past. The benefits to shareholders, communities and the business itself in providing a transparent narrative on its operations are undisputable. The use of technology should aid companies to keep legislative routine reporting separate from more strategic and forward thinking disclosures. Traditionally there was one document – the annual report and accounts – which contained the vast majority of legislative disclosures that companies were required to make. Some new regulation, such as that on reporting under the Modern Slavery Act and payment to suppliers requires reporting to be on a website rather than in the annual report. It is likely that the drive to presenting more information and reporting online will to continue enabling companies to provide a greater variety of information of use to different audiences whilst keeping the annual report for key business messages.

At a more fundamental level, the role of the strategic report in fulfilling its legal purpose of demonstrating how directors have discharged their duties under section 172 to promote the success of the company, is coming again under the spotlight. Reporting on ethics, employees and environmental matters will be increasingly scrutinised to ensure that directors are fulfilling their responsibilities under section 172.
Useful Sources
FRC: Guidance on the Strategic Report (June 2014)
FRC Lab Project Report: Business Model Reporting (October 2016)
FRC: Clear and Concise: Developments in Narrative Reporting (December 2015)
International Integrated Reporting Framework (December 2013)

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APPENDIX

Voluntary Reporting Schemes and Guidance

There are many bodies which seek to improve the quality and transparency of non-financial reporting as part of their remit to encourage responsible business practices particularly in relation to environmental and social matters. However, whilst the aims of these bodies may be laudable, concerns have been raised that there are too many, all with their own agenda, which can lead to confusion both for reporting companies and stakeholders. Some of the most influential of these initiatives are outlined below.

**Global Reporting Initiative (GRI)**
Many companies, particularly those in mining and extractive industries, chose to adopt standards of reporting championed by the GRI. This is an organisation set up in the 1990s to help businesses, governments and others understand and communicate the impact of business on sustainability issues such as human rights, climate change and corruption. According to the GRI website 92% of the world’s largest corporations report on their sustainability performance of which 82% use the GRI sustainability report guidelines.

**UN Global Compact**
The UN Global Compact sets out ten principles concerning human rights, anti-corruption, labour and the environment which it encourages companies to sign up to. Reporting on the implementation of these principles is key to being a member of the UN Global Compact. The UN Global Compact is named by the European Commission as one of the guidelines that companies can use to assist in their disclosure of non-financial information.

**FTSE4Good Indices**
The FTSE4Good Index Series measures performance of companies with strong environmental, social and governance practices. A set of criteria are used to assess ESG performance based on publicly available data. Companies are given ratings from 0 to 5, with 5 being the highest. Given that assessment is based on public data and the PR benefits of being highly rated by FTSE4Good encourages businesses to strengthen their performance and reporting in these areas.

**The Equator Principles**
The Equator Principles are a set of guidelines for financial institutions to help them assess the environmental and social impacts of the projects they invest in. Those institutions that seek to apply the Equator Principles commit to investing only in projects that have been assessed for environmental and social risks and have an action plan for addressing these risks. The financial institutions also commit to annual reporting on how the Equator Principles have been adopted.