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Draft amendments to Guidance on the Strategic Report - Non-financial reporting; Response from United Kingdom Shareholders' Association (UKSA) and The UK Individual Shareholders Society (ShareSoc).

I. Approach to update

Q1 Do you agree with the approach for updating the Guidance for the changes arising from the implementation of the non-financial reporting Directive?

No. We would have preferred to see a wider review of the guidance. The FRC states in its briefing note on the consultation (Introduction vi):

'Broadly, the feedback on the Guidance on the Strategic Report to date has been that it is a helpful document, therefore this update is not intended to be a fundamental review.'

This argument is weak. Just because the existing Guidance has been said to be helpful does not mean that there is no need to carry out a wider review. Even a cursory glance at the structure and content of the strategic review produced by most companies suggests that there is a need for a much wider and more fundamental review of standards of reporting in this area and that the Guidance requires a major re-think.

However, given that the FRC has decided that the review will not to be fundamental and that it is to address only the relatively narrow and specific issues set out in Section v of the Introduction to the consultation, then the approach adopted for the updating is probably appropriate. This does not alter our belief that, from an investor point of view, the Guidance remains deficient.

II. The purpose of the strategic report and section 172

Q2 Do you support the enhancements that have been made to Sections 4 and 7 of the Guidance to strengthen this link?

Yes, with provisos contained in our detailed feedback at the end of this document.

Q3 Do you have any suggestions for further improvements in this area?

Please see comments on our detailed review at the end of this document.

III. Materiality

Q4 Do you agree with the draft amendments to Section 5?

Although it does not relate specifically to Section 5, we have commented in our detailed feedback on S414 C 14 in Appendix IV of the guidance. S414C14 appears to provide a ‘get-out’ which allows companies to avoid disclosing anything, regardless of materiality, if they so choose. This is wide open to abuse.

IV. Linkage

Q5 Do you have any suggestions on how the Guidance could encourage better linking of information in practice, or common types of disclosures that would benefit from being linked?

This is partially addressed in the revised Guidance. The problem is that, given the fundamental deficiencies in current approaches to strategic reporting (deficiencies which the FRC has made it clear it does not intend to address), linking of information and disclosures so that they can be more easily accessed, followed and understood by investors is likely to remain seriously inadequate.

The move to digital reporting which has the potential to make it easier for investors to find their way around the AR will provide a basis for ensuring better linkages. However, digital reporting on its own will not necessarily achieve this. It will still remain necessary for companies in compiling digital versions of their AR to ensure that appropriate links are inserted that, they work and that they are easy to use. For example, nothing is more annoying than being given a link to a website from which you cannot get back to the original document.

V. Content elements

Q6 Do you agree with how the sources of value have been articulated in the draft amendments to the sections on strategy and business model in Section 7?

Please see comments contained in our detailed feedback on the Guidance at the end of this document.

Q7 Do you consider that disclosures on how value is generated would be helpful?

This is a very interesting question on which the FRC should reflect carefully. As with so much other reporting more and more requirements have been added on a piecemeal basis to try and make other fundamentally deficient disclosure more meaningful. The result is patchwork jumble of semi-coherent and badly defined requirements which are often inadequate and sometimes counterproductive in providing investors with the information they need and want. The business model should make it crystal clear how a business generates value (note that ‘value’ needs to be defined here). Unfortunately, most business models resemble little more than a cross between a consultant’s PowerPoint presentation and a primary school children’s project. They are full of jargon, cliché, buzz-words strung together, four-box models, meaningless reconstructions of virtuous-circles and all liberally interspersed with silly and often irrelevant graphics that often add nothing and simply patronise the reader.

Rather than adding another bell or whistle to the exiting unsatisfactory regime by suggesting to companies that they should report separately on how value is created it would be better have stronger and clearer guidance on business model reporting and on the presentation of the company’s key objectives and the business strategy which it is implementing to achieve the objectives.

This, in part, is why we feel strongly that a more fundamental review of the Guidance on non-financial reporting is needed.

Q8 Do you consider that the draft amendments relating to reporting of non-financial information give sufficient yet proportionate prominence to the broader matters that may impact performance over the longer term?

Within the context of a fundamentally flawed approach to non-financial reporting and without becoming excessively prescriptive, they probably do.

VI. Other

Q9 Are there any other specific areas of the Guidance that would benefit from improvement?

Please see comments relating to the Appendices in our detailed review at the end of this document.

Detailed Review

Specific comments on the new guidance for the Strategic Report

Guidance Section	Comments on the proposed guidance
P3 Background – section iii	The purpose of the strategic report needs at least to be summarised in this section. It is not enough to exhort companies to produce something that is clear, concise, fair etc. There needs to be something which makes it clear why these attributes are so important e.g. that the strategic report (SR) provides critical information to investors which will allow them the understand the strategic direction that the directors have set for the company and which will also demonstrate how this is supported by the business model and how, for example, management's targets and rewards support the achievement of the business strategy. Other sections such as 6.20 go some way towards covering the issue of linkages between sections of the report. However, a clear statement about the coherence of the strategic report is needed in the Background section of the Guidance. The SR should not be a series of disjointed topics thrown together to meet compliance requirements. The objective of the strategic report is stated in Section x of Overview (p4). This single objective is very broad. It is an objective that is also wide open to manipulation. Most strategic reports are full of hubris and hyperbole. Carillion's SP talks in glowing terms of the 'Board being committed to ensuring that Carillion maintains and continuously improves its structures and processes required to underpin the effective delivery of its growth strategy'. This meets the defined objective of Carillion's SR. Sadly the strategy itself seems to have been a total failure.
P3 Background – iv	Is the target date of 31st December 2017 for companies to start implementing the new guidance realistic? Consultation is due in by late October. By the time the new guidance is ready for publication it will be almost the end of 2017.
P4 Overview – vi	The Guidance states: 'While the Guidance on the Strategic Report is advisory rather than mandatory it nevertheless represents a statement of good practice which investors are likely to see as a basic requirement in corporate reporting'. This is too woolly. In what way is the Strategic Report a statement of good practice? Good practice about what? We would also prefer the FRC to avoid vague clichés like 'enabling entities to tell their story'.

P4 Overview – viii	The last sentence would benefit from an example e.g. the link between strategic objectives for the business and targets set for directors' remuneration.
P5 Overview - xiv	After the words 'key performance indicators' add '*and how these link to the performance measures used in the remuneration report'*
P5 Section 1 – 1.3	Linkage example: this states that one of the main objectives of the guidance is to 'encourage the preparation of more cohesive annual reports'. Providing linkages is often only necessary because the structure of the Strategic Report is so poor in the first place. It is the basic lack of coherence and logical structure which needs to be addressed first and foremost.
P7 Section 1 - 1.3 Encouraged Content element	The wording in the box is very vague. It gives no meaningful guidance - e.g. brief examples of what might constitute 'encouraged content'. The concept of encouraged content justifies better guidance than this.
P10 Section 3 – 3.2	This may be the purpose of the AR as defined by the Companies Act. However, as 3.4 acknowledges, the AR may (*may* should be strengthened to read *will often*) also be a key document for prospective owners of shares and others such as customers and suppliers who may be considering entering into a trading relationship with the company. The statement is also unclear and confusing. Isn't it the directors who make the 'resource allocation decisions' rather than the shareholders? If the purpose of the AR is to help investors make *investment decisions* then why not say this?
P11 Section 3.6	Meaning of 'Position' is not clear.
P16 Section 4 - 4.3	Strategy, Performance, Development, Position and Impact require some sort of definition. Some of these may seem obvious but 'Position' certainly requires a definition in the context of the strategic report. 'Impact' also needs defining in order to understand its scope in the context of the strategic report. Neither Position nor Impact is defined in the glossary (Appendix 1).
P20 Section 5 – 5.15	We fully support the final sentence *('It is not a general derogation applying to all commercially sensitive information'*).
P23 Section 6 - 6.23	We agree with all that is being said here. However, comment is needed on the way in which companies typically structure their SR. Taking Huntsworth plc as an example (because it's SR is far less complex than, say, a company like Babcock), the SR consists of: a Chairman's Statement; Chief Executive's Review; seven pages of 'puff' about the Company's brands; Our Strategy; Chief Financial Officer's Report; Responsible Business; Principal Risks. This sort of structure is guaranteed to ensure that related information is fragmented and scattered around in the SR in a way which makes it difficult for investors to find, assimilate and understand. It is also a model for encouraging repetition. Some of the content manages to be both superficial and verbose at the same time. Some is little more than self-promotion which is long on hubris and light on fact. Section 7 suggests that the FRC is aware of the problem outlined above. Firmer guidance on appropriate structures for the SR would not go amiss.
P25 Section 7 – 7.1	The graphic showing the content elements of the Strategic Report is both good and interesting. It is also a tacit acknowledgement that most strategic reports are not fit for purpose. Why not simply write the Strategic Report around the three categories set out in the model in 7.1? Why does the information required by these three categories have to be buried in a hopelessly inappropriate structure adopted by Huntsworth and many others? This is the sort of guidance that would benefit shareholders in ensuring that companies

	provide them with more succinct and meaningful information.
P25 Section 7 - 7.2	We agree with the new insertion.
P26 Section 7 – 7.8	It is not clear why 'objectives' have been deleted. These are of vital importance to anyone who wants to understand a company's strategy. Stating a company's purpose is valid and helpful but it is not a substitute for stating its business objectives. Without a clear statement of measurable business objectives it is hard for investors to understand how the business is performing against these objectives and how the pay structure for directors links to the achievement of objectives.
P26; Section 7 – 7.10	Do not agree with this. It sounds back-to-front. A business would normally set a number of commercial objectives. The strategy sets out how it plans to achieve these objectives over a given time-frame. The objectives are not drivers of the company's values. The company can state its values and how these values help it to achieve its strategic objectives. It may put a number of KPIs in place to allow it to monitor whether it is maintaining its values. The values, however, support the achievement of the objectives – not the other way round as suggested in the guidance.
P28; 7.14 Linkage example	We strongly support the addition of guidance on the discussion of cultural issues in the Strategic Report. However, it is important that the guidance is not obscured by cliché and doubtful logic. 'Value chain' has recently attained a place in the lexicon or popular jargon. It is the sort of jargon that the Guidance (rightly) urges companies to eschew. What does the term 'value chain' mean here? Is it the market sector in which the company operates? Is the position that it fills in the wider supply chain for a given product / service? Without knowing this the correctness and logic of the statement that follows is debatable. The company's values, behaviours and cultures should be appropriate for and support its market positioning (place in the value chain?). The market positioning does not support the company's values, behaviours and cultures.
P28; 7.15 Example	The example is weak. In the pharmaceuticals field any company developing new drugs would see the development and approval process as fundamental. Not only is it an area of huge cost for most pharmaceutical companies, it is an area of great risk. A better example would be to that of a supermarket which had outsourced all its logistics. Logistics may not be part of its own business model any longer but it is still highly dependent on the efficiency of the logistics operation to ensure that the shops have goods on the shelves. This example also raises interesting issues about linkages to risk – namely that the supermarket is highly dependent for its success, and even its survival, on a third-party supplier/s. Questions this prompts for investors might include, how was the outsourcing decision made, who are these critical suppliers and how are they monitored and managed? How does the company know whether it (and its shareholders) are getting value for money out of them?
P28; 7.17	Need to mention outsourced services here. Many companies are now very dependent on skills, assets, expertise and know-how that no longer resides in-house. The sections that follow on stakeholder relationships do not give sufficient weight to the specific issue of key supplier-relationships.
P30 Section 7 – 7.24	The term 'principle risks' requires clearer definition. The term is covered in the glossary (Appendix1) and it is clear that it covers those risks that could threaten the future survival of the entity. There needs to be clearer guidance on other

	types of 'principle risk' and how they are described. Carillion's 2016 AR is a classic piece of obfuscation in this respect. 'Contract management' is shown as a principle risk in the Risk Report (red alert). However, there is no indication as to why it is seen as being such a high risk or that the company has serious concerns about some of its major contracts. Just a few months after the publication of the report the company's share price imploded when it revealed serious difficulties with a number of large contracts. Technically, Carillion's risk report is compliant. In terms of investor information it is useless.
P34; 7.38	There is an implication here that it is acceptable to have different bribery rules within a UK company for the different jurisdictions in which it operates. Our understanding of the 2010 Bribery Act, however, is that it makes bribery an offence for a UK company regardless of where it operates or where the bribery takes place.
P34; 7.39 Also P36; 749 and following on KPIs	There needs to be reference here to the relevance and robustness of the KPIs that are chosen. All too often KPIs are used which lead to perverse behaviour by directors and employees. For example, a strong focus on EPS growth has lead to companies buying back their own shares (often at high valuations) just to boost EPS and allow directors to meet a key performance target and receive their bonus – regardless of the fact that, in most cases, shareholder value has been destroyed.
P34; 7.41	The term 'Position' needs to be defined – both here and in the Glossary.
P 37; 7.57	We agree with the proposed additional guidance on alternative performance measures (APMs).
P38; 7.58 – 7.66	We agree with proposed additional guidance on disclosure of Trends and Factors.
P45 Appendix 1 - Glossary	The term 'Position' is used in several places in the guidance but is not defined. A clear definition is needed. We have no comments on other proposed amendments to the glossary.
P46 Appendix 1 - Glossary	'Purpose' needs to be more clearly defined here. There needs to be more reference to Section7.5 and the fact that purpose must be company specific and related to both strategy and the business model. As defined in the glossary (P46) 'purpose' could simply be construed as 'making money'.
P47 Appendix II	There is no Appendix II shown. It would be better to renumber the Appendices (from III onwards) to take account of this.
P47 Appendix III	We have no comments on the proposed amendments to Appendix III.
P55 Appendix IV S414 C (3)	Reference to an entity's 'Position' – the4 term 'Position' needs to be defined.
P58 Appendix IV S414 C 14	This statement is not satisfactory. It provides a get-out for companies that fail to release bad news in the AR and which then do so shortly afterwards. If a takeover or a merger is being discussed it is understandable and reasonable that a company might not want to release this information. However, Carillion. For example, must have known that it had serious problems with a number of its contracts when it released it s 2017 accounts. There is no excuse for this not being raised in the AR and in a way that cannot be missed by investors.
	End of commentary