The Strategic Report - something to get you thinking

by Peter Parry

Once again Ian McDonald Wood of Future Value has contributed a thoughtful article (below) based on his regular blog. This time he discusses the changes and amendments that the FRC has included in its revised guidance to companies when drafting the Strategic Report. The FRC has asked for comments and feedback on its proposals. The revised guidance can be found by going to: https://tinyurl.com/ybguytf9

This takes you to a link: Staff Draft Guidance on Strategic Report which when you click on it will open a PDF copy of the draft guidance. It is helpfully marked up showing all the proposed amendments. The draft guidance raises many issues, some of the most important of which Ian has picked up in his article. UKSA will be submitting a response to the consultation which is likely to echo many of Ian's thoughts and add to them. In formulating our response it would be good to receive the views and comments of as many UKSA members as possible. Please do send any feedback to officeatuksa@gmail.com. The closing date for submissions to the FRC is 24 October 2017, so we shall need your comments by at least 17 October.

It is easy to be critical of some of the outputs from the FRC. However, there can be little doubt that as part of its work the FRC is often shining a light on reporting issues that should have been reviewed a long time ago. The mere fact that the Regulator is prompting an open debate, consulting stakeholders and asking investors for their views and comments are reasons for us to support and applaud the FRC and its work while also providing constructive criticism.

An untimely excess of reporting guidance

by Ian McDonald Wood

A belated consultation on extensive changes to the Strategic Report just launched will make life difficult for all the reporting companies with 31/12 year-ends, creating twin challenges of timing and scope. Did it really all have to happen like this in an unseemly hurried rush?

The FRC has just published draft guidance on revisions to the Strategic Report and launched a consultation inviting comment by 24 October. The primary reason for the guidance is to address the incorporation of the EU Directive on Non-financial reporting into the Strategic Report. Companies with 31/12/2017 year-ends will be the first to apply the changes. There are two challenges here.

The first challenge is a matter of timing. The underlying statutory reporting requirements on which the guidance is based first applies to companies with year-ends on 31 December 2017. Over 60% of FTSE350 reporting companies at least will be hanging on for the final guidance. So, there will follow an unseemly rush in November to assimilate the consultation replies, assess them and incorporate consequent changes into the final guidance before the end of November. And in the scramble how good will that final guidance be?

The second challenge is a matter of scope. FRC has added an extra degree of difficulty to the process by deciding in the same draft guidance to make substantial revisions to the content of the Strategic Report that go beyond the requirements of the EU directive. These additional changes are intended to remedy shortcomings in the original 2013 guidance. They also address FRC's belated realisation that reporting is the means with which Directors should demonstrate that they are promoting the success of their companies as defined in Section 172 of the Companies Act.

Some of the additions in the Guidance are to be applauded. The regulator is using the EU directive as the means to make the content of the strategic report more accurately reflective of its title and more demonstrably 'strategic'. And, looking at this draft guidance with a strategist's eye, this amounts to a significant improvement on the 2013 guidance. However, the new draft still demonstrates a lack of intuitive understanding of strategy by those within the FRC charged with making the revisions and with writing the guidance.

On the plus side FRC is asking Boards to take a longer term and holistic view of their businesses. The guidance is also putting some emphasis on intangibles, hidden assets and other resources that have been expensed off the balance sheet. There is the addition of 'purpose'. FRC has also added 'position'. The regulator at last sees the business model as having primarily strategic value and not optionally as some explanation of an entity's operational processes. The guidance additionally talks about alignment. It also asks companies to address sources of value. These are all positive additions from the strategist's perspective.

But, despite the positives, the guidance does not build the structure of a simple, logical strategy framework that will convey instinctive meaning about long term value to shareholders. In adding 'purpose' the guidance explicitly drops 'objectives'. 'Purpose' is the constant that tells investors why an entity exists. 'Mission' should then add strategic direction to 'purpose', while 'objectives' are the measurable outcomes along the way. So, why aren't 'objectives' essential still in FRC's estimation? 'Position' to the strategist is key, but FRC offers no definition of what it means here, leaving it open to misinterpretation. FRC may now see 'business model' as more strategic than operational, but it still does not see the model as the fundamental determinant of an entity's strategy and the setting of its objectives. In fact, the guidance now bizarrely describes objectives as the consequence of purpose. Intangibles are also about more than just relationships.

The strategy framework proposed by the FRC's guidance simply doesn't hang together. And if strategists cannot follow the strategic logic, then neither will investors looking to improve their sense of certainty about the future potential of a business.

And how will the new guidance and its precursory consultation go down with FRC's various stakeholders? A large proportion of reporting entities will start working on their 2017 Strategic Reports long before the consultation responses are due in. So, they are unlikely to see the FRC's actions and timing here in a positive light. As for investors, the added scope and additional material is more likely to add confusion than clarity. It will probably only be the wider groups of stakeholders who will welcome the changes, largely due to the inclusion of non-financial aspects covering social and environmental dimensions.

The reality is that the FRC is using the EU directive and its incorporation into UK legislation as some sort of trojan horse to conceal other quite complex changes – although there are no gifts for anyone here. FRC says that its "*aim is to encourage companies to be innovative in this space [….]*". 'Innovative reporting' is an oxymoron to virtually all FTSE350 companies. Most are constantly looking to see what others have done before introducing any reporting change. And since few companies have yet to produce truly useful strategic reports, these relatively far-reaching revisions will challenge most companies yet further.

If FRC can't provide more directive guidance that gives reporting companies a simple, logical framework to adopt and follow, then we will continue to see an abundance of mediocre, design-led, content-weak, uninformative Strategic Reports that are of limited value to investors. Giving clear direction does not amount to being prescriptive.