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4 April 2016

Dear Mark,

**The Non-Financial Reporting Directive: A call for views on effective reporting alongside proposals to implement EU requirements**

We welcome the Department of Business, Innovation and Skills (BIS) consultation and in particular the opportunity that BIS has taken to consider broader aspects of corporate reporting. As you are aware, the Financial Reporting Council (FRC) attaches great importance to Clear & Concise reporting and we believe that starting the debate on the issues in the consultation document will lead to improvements in the quality and relevance of information in annual reports.

Our overarching comments are highlighted below with our detailed responses to the questions in the consultation document included in the Appendix. Our response has been informed by views that we have sought from investors and companies.

*(a) UK narrative reporting framework*

In our view, the UK has a well-developed framework for narrative reporting that has been enhanced by the introduction of the Strategic Report. As noted in the FRC's recent report *Clear & Concise: Developments in Narrative Reporting*, this has led to improvements in the quality of reporting<sup>1</sup>.

We note that one of the aims of the EU Directive on disclosure of non-financial and diversity information (the 'non-financial reporting Directive') is to create a level-playing field across Europe for reporting non-financial information. With that in mind, we believe that it is important to retain the key principles in the Strategic Report when implementing this Directive and reduce complexity for UK companies. We frame our comments within this context.

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<sup>1</sup> A copy of the report is available at <https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Clear-Concise-Developments-in-Narrative-Reporti.pdf>

*(b) Scope*

We believe that BIS should retain the existing scope for reporting of non-financial information in the Strategic Report (quoted companies) and extend to include other Public Interest Entities as defined in the Accounting Directive.

Simply applying the scope set out in the non-financial reporting Directive would result in fewer UK companies being required to disclose non-financial information. We consider that this would result in a loss of transparency for investors and create complexity in the UK narrative reporting framework as it would result in the introduction of a new reporting threshold.

*(c) Assurance*

We do not support the introduction of additional mandatory requirements for verification of non-financial information by an independent assurance services provider. We note that the auditing standards require auditors to perform some procedures over other information (financial and non-financial) included in the annual report (e.g. the Strategic Report).

We believe that any demand for additional assurance should be market-led and to date we have not seen evidence from investors for a need for further assurance over non-financial information or for other parts of the narrative report. Furthermore, we consider that a requirement for assurance could drive companies down a compliance route, detracting from the ability of companies to 'tell their story' in the Strategic Report and be an additional cost for companies.

*(d) De-regulation*

We support the government's drive towards de-regulation as this would be a step towards reducing the disclosure burden for companies. In our view, there is scope to improve some areas of narrative reporting that would result in more relevant information for investors. These include:

- removing the Directors' Report as this has been superseded by the Strategic Report - as a minimum, we believe that there is scope to remove some disclosure requirements in the Directors' Report that are no longer relevant, duplicate those in accounting standards or have been superseded by requirements in the Strategic Report;
- making the remuneration report more concise by reducing the number of reporting requirements; and
- amending the requirement to list all subsidiaries, not just principal ones, in the annual report that has resulted in a significant increase in the number of pages.

Our specific suggestions for de-regulatory measures and areas for improvement are included in our response to questions 13-16.

*(e) Electronic reporting*

We welcome the fact that BIS is exploring the use of electronic reporting as part of this consultation. As a general principle, we consider that when non-financial information is material to investors, that information should be included in the Strategic Report.

However, we recognise there may be more detailed information that may not be material in the context of the annual report but may nonetheless be useful or is necessary to meet a legal requirement (e.g. detail on policies or processes). We encourage BIS, as part of the UK implementation of the non-financial reporting Directive, to explore how best to provide companies with flexibility on where they report information. This will be a step towards ensuring that the annual report is a concise communication of the key information for a company's investors.

If BIS decides to retain the Directors' Report, we encourage BIS to re-visit the idea of the Annual Directors' Statement that was supported by the majority of respondents to the 2011 consultation 'The Future of Narrative Reporting'. This would involve moving the Directors' report on-line. Since the introduction of the Strategic Report, the Directors' Report has become a repository of compliance data to meet legal requirements that are not subject to a materiality filter.

(f) *Guidance*

We note that the consultation document refers to the FRC's Guidance on the Strategic Report<sup>2</sup>. The FRC is standing ready to work with BIS to update the Guidance for any consequential amendments arising from the outcome of the consultation.

If you would like to discuss these comments, please contact Deepa Raval on 020 7492 2424.

Yours sincerely

A handwritten signature in blue ink that reads "M McLaren" with a horizontal line underneath the name.

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<sup>2</sup> <https://www.frc.org.uk/Our-Work/Codes-Standards/Accounting-and-Reporting-Policy/Clear-and-Concise-Reporting/Narrative-Reporting/Guidance-on-the-Strategic-Report.aspx>

## Appendix

We have structured our response to the questions in the consultation document around the following broad themes:

- scope of the non-financial reporting requirements;
- placement of non-financial information;
- assurance over non-financial information;
- de-regulatory measures and areas for improving existing disclosures; and
- electronic reporting.

### *Scope of the non-financial reporting requirements*

#### **Scope**

##### **Q4) Advantages and disadvantages.**

What do you see as the advantages and disadvantages of the various implementation options?

##### **Q5) Preferred option relating to scope**

Considering the possible advantages and disadvantages provided by the flexibilities contained within the EU NFR Directive, which would be your preferred option in terms of which companies should be required to disclose non-financial information?

##### **Q6) Alternative Options**

Are there any other options for implementing the EU NFR Directive the Government should consider?

**Q5, 6)** Our preferred option relating to scope is an alternative to Options 1 and 2.

As noted in our cover letter, the existing requirements for disclosing non-financial information in the Strategic Report are substantially aligned to those in the Directive and apply to UK quoted companies. In our view, it would be a retrograde step in terms of transparency for investors to reduce the scope to large Public Interest Entities with more than 500 employees ('large PIEs') only.

We also note that the existing narrative reporting framework in the UK is already complex as there are different thresholds that determine the level of disclosure that a company needs to provide depending on whether a company is small, medium, large or quoted. Whilst we support proportionate disclosure requirements, we consider that introducing a new definition of 'large PIEs' would be an additional layer of complexity.

**Q4)** We believe that Option 1 (separate content requirements for large PIEs within the scope of the Directive and quoted companies based on the content of the Companies Act 2006) is confusing and is unlikely to be practicable. As noted in the consultation document, having two layers of similar content requirements based on different scope criteria would create complexity and could result in a company reporting slightly different content in different years if it becomes a large PIE and vice versa.

We do not support Option 2 for the reasons set out in our responses to question 5 and 6 above. However, we can see that selecting this option would reduce the number of mandatory disclosures for some companies.

#### *Placement of non-financial information*

#### **Location of Information**

##### **Q1) Flexibility on where to provide the non-financial statement:**

What is your view on permitting companies flexibility to place information where they feel most appropriate within the boundaries laid out by the EU NFR Directive? Please explain your reasons.

##### **Q2) Information that could be placed in a Separate Report**

We would welcome suggestions for information, currently required by law that could be placed in the separate report.

##### **Q3) Advantages and Disadvantages of a separate non-financial statement:**

What do you see as the advantages and disadvantages, for your organisation of the separate statement?

**Q1)** The introduction of the Strategic Report Regulations, supported by our Guidance, and the Corporate Governance Code requirement for annual reports to be fair, balanced and understandable have led to significant improvements in the quality of reporting in the UK. Our Guidance highlights the need for annual reports to provide a single cohesive and coherent view of the company, integrating narrative and quantitative information, both financial and non-financial and that this be done through clear and concise reporting. Our December 2015 report *Clear & Concise: Developments in Narrative Reporting* shows that reporting continues to develop and improve in this area.

We are concerned that inappropriate implementation of the non-financial reporting Directive, and in particular decisions on the placement of non-financial information, could undermine the progress to date and damage the quality of reporting.

The provision of non-financial information is, to varying degrees, often necessary for investors to understand a company, its strategy, performance and position and the principal risks it faces. Therefore, if the current non-financial reporting requirements in the strategic report are removed and replaced with those in the non-financial reporting Directive with an option to place all of this information outside of the annual report, then the quality of reporting in the annual report will be diminished. Investors will not be provided with a complete and coherent understanding of the business; the annual report will not be clear.

On the other hand, if the entirety of the requirements in the non-financial reporting Directive are placed within the Strategic Report and these requirements are applied without proper consideration of whether or not they are material to providing investors with relevant strategic information on the company, then the quality of the annual report will diminish through additional clutter; the annual report will not be concise.

Therefore, we recommend that the non-financial reporting requirements be placed within the annual report, but it be clear that their inclusion in practice be subject to the same criteria as currently applied in the Strategic Report. In other words, only information that is of strategic importance need be included.

We also recommend that it be made clear that the annual report can signpost to further information outside of the annual report. The notions of sign-posting and cross-referencing were included in our Guidance on the Strategic Report and there is evidence of them being applied in practice. There is support from companies for including ‘standing data’ (i.e. information that does not change year to year) online.

A specific example of information required by the non-financial reporting Directive that might not be of strategic importance in every period is the disclosure of a company’s processes, including due diligence, in relation to non-financial matters. If these processes do not change from period to period then detailed explanations are unlikely to be of strategic importance. In such cases, we recommend that companies be permitted to direct users to where such processes can be found outside of the annual report, most likely on the company’s website, with only material changes to those processes being explicitly described in the annual report.

Where companies are reporting information on a website, we believe that it is important that this information is given equal prominence to the annual report itself and can be easily located. For example, there could be a central digital location on a company’s website that enables users to easily navigate to different types of company reports. In addition, we have heard from investors that they value having a clear boundary and time stamp on electronic communications.

**Q3)** We have heard from some companies that one of the benefits of including non-financial information in a separate report is that it would ease some of the pressure of the year-end reporting process. We note that where Member States select the option in the Directive to publish non-financial information outside the annual report, it can be published up to six months after the balance sheet date.

Another benefit would be avoiding duplication where a company already prepares a separate Corporate Social Responsibility or Sustainability report containing similar information.

In our view, the main drawback of publication of non-financial information separately is the risk that non-financial information that is material for investors is excluded from the annual report.

**Q2)** See our response to question 16 below.

*Assurance over non-financial information*

#### **Validation of non-financial information**

##### **Q7) Assurance of Non-Financial Information**

Should the Government require that the non-financial statement be verified by an independent assurance service provider’?

##### **Q8) Advantages and Disadvantages of third-party validation**

What do you see as the advantages and disadvantages of requesting third party assurance?

##### **Q9) Other Options**

Are there any other options the Government should consider for Third Party Verification?

**Q7, 8, 9** For the reasons set out in our covering letter, we do not support the introduction of additional mandatory requirements for assurance over non-financial information.

International Standard on Auditing (ISA) 720 *The Auditor's Responsibilities Relating to Other Information* requires auditors to report on whether other information included in the annual report is materially inconsistent. For audits of financial statements for periods ending on or after 15 December 2016 auditors will also be required to report on whether the reporting framework (including Strategic Report and Directors' Report) has been correctly applied.

We recognise that there may be situations where a company voluntarily chooses to obtain additional assurance but we consider that companies should have flexibility to determine whether it is necessary according to their specific circumstances rather than through the introduction of further regulatory requirements.

#### *De-regulatory measures and areas for improving existing disclosures*

### **Reporting Regulations**

#### **Q15) Reporting Regulations**

What other reporting regulations would you suggest that could be repealed?

#### **Q16) Other Information**

Is there any information that could be moved outside the Annual Report?

**Q15)** We believe that the Directors' Report could be eliminated in its entirety and have heard from companies that much of its content is no longer relevant and not discussed by the Board following the introduction of the Strategic Report. As a minimum, we consider that there is scope for a number of the requirements in the Directors' Report to be repealed and we encourage BIS to review these.

#### *Directors' report*

As noted in our 2012 Discussion Paper 'Thinking about disclosures in a broader context'<sup>3</sup>, different regulators setting similar requirements for different parts of the annual report and other forms of corporate reporting contributes to disclosure overload. Therefore, when considering de-regulatory measures we believe that it is important to consider the total package of corporate communications.

We note that many of the reporting regulations set out on page 24 of the consultation duplicate information that is publicly available elsewhere and therefore we support its removal from the annual report.

In addition, we suggest removal of the following requirements from the Directors' Report. The principles that we have applied in making our suggestions are where requirements:

- are likely to result in information that is of limited relevance to investors;
- duplicate those in accounting standards; and
- have been superseded by high-level principles in the Strategic Report.

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<sup>3</sup> <https://www.frc.org.uk/getattachment/99bc28b2-c49c-4554-b129-9a6164ba78dd/Thinking-about-disclosures-in-a-broader-context.aspx>

Regulations reference <sup>4</sup>	Disclosure	Rationale
Sch 4.2(2-3) <sup>5</sup>	Information on charitable donations	Only a requirement for small companies – removed as part of Strategic Report regulations for other companies.
Sch 7.7(1)(a)	Post balance sheet events	This information duplicates the requirements in accounting standards.
Sch 7.7(1)(b)	Indication of likely future developments in the business	Superseded by the general requirement in the strategic report to include the main trends and factors likely to affect the future development, performance and position of the business.
Sch 7.7(1)(c)	Research & development activities	If these are material, they will be covered in the Strategic Report
Sch 7.7(1)(d)	Existence of branches	This disclosure may not provide relevant information.
Sch 7.10(3) Sch 5.5(3) <sup>5</sup> 7.11(3)	Detailed employee disclosures (e.g. policy on employment of disabled persons; duty to provide information that is relevant to employees)	Covered by the broad requirement to report on employee matters in the Strategic Report.

We have heard from investors that information on political donations is useful (Sch 7.3 & 4 Sch 5.2(2-3) & 3(1)<sup>5</sup>), however, we would encourage BIS to increase the threshold for reporting this information (from donations in excess of £2,000 to £100,000) as investors stress the importance of including only material information.

**Q16)** After taking into account the above, we consider that there is no longer a need for the Directors' Report. As noted in our covering letter, since the introduction of the Strategic Report requirements, the Directors' Report now contains other statutory disclosures that may not be relevant to investors. If these disclosures are still needed then we consider it would be better for the information to be reported outside the annual report to facilitate concise communication of relevant information to investors. A specific example of detailed information that lends itself to reporting online is the disclosure of Green House Gas Emissions (Sch 7.15-20).

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<sup>4</sup> References are to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations unless stated otherwise.

<sup>5</sup> Small Companies and Groups (Accounts and Directors' Report) Regulations

## *Remuneration reporting*

As part of its broader de-regulatory agenda, we recommend that the government undertakes a review of the effectiveness of the remuneration reporting regulations introduced in 2013. We have heard from companies that the remuneration regulations are not effective and there is scope to shorten the report by simplifying the requirements. The FRC's Lab Project Report: A Single Figure for Remuneration<sup>6</sup> provides further insights. Examples of disclosures that can be removed as they are unlikely to be relevant to investors include - the statement of consideration of employee conditions elsewhere in the company, relative importance of spend on pay.

## *Improvements to existing disclosure requirements*

### **Gender Reporting**

#### **Q13) Definition of Senior Manager**

BIS would welcome suggestions as to how this definition may be improved to reflect better the intention of this requirement.

#### **Q14) Other Comments on this requirement**

BIS would also welcome other comments on this regulation including views on the approach suggested

**Q13)** As currently drafted, for groups, the application of the requirements in S414C(10) of the Strategic Report regulations is resulting in a disclosure that is not meeting the intended policy objective – to show the gender diversity of the talent pipeline.

The part of the regulation that is problematic is the application of the definition of senior manager in the consolidated Strategic Report for a group (S414C(10)(b)) as it requires disclosure of the number of persons of each gender that are directors of each subsidiary. These may not necessarily be senior managers of the group as not all the directors of subsidiary undertakings will have responsibility for “planning, directing or controlling the activities of the [group]” (s414C(9)(a)).

We suggest that 10 (b) is replaced with the following:

“the reference to the company in subsection (8)(c)(ii) is to the group”.

**Q14)** In addition, we note that in practice, many companies are disclosing percentages rather than absolute numbers as set out in the regulation. We encourage BIS to consider whether the requirement could be made more flexible to permit disclosure of percentages as this may assist in presentation of information in a more understandable format.

We consider that gender diversity information is useful for employers to make an assessment of their talent pipeline but it focuses on a specific aspect of diversity. In light of the forthcoming regulations from the Gender Equalities Office on Gender Pay Gap reporting, we encourage BIS to consider the placement of this requirement. There may be merit in grouping this detailed

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<sup>6</sup> A copy of the report is available at <https://frc.org.uk/getattachment/3a986efa-82e5-4f08-b70c-a2ffc22dedc5/FRC-Lab-A-single>

disclosure requirement with the pay information on a website or move it to the Directors' Report with other detailed disclosures on some aspects of non-financial reporting.

### *Subsidiaries*

Companies have highlighted to us that the requirement (s409 Companies Act 2016<sup>7</sup>) to list all subsidiaries in the notes to the financial statements is resulting in the disclosure of irrelevant information and is inconsistent with the objectives of Clear & Concise reporting.

This has arisen as a consequence of the UK implementation of the EU Accounting Directive (2013/34/EU). The Directive permits the list to be filed either with the registrar of companies (Companies House in the UK) or in the annual report.

The concession (S410) that allowed companies to report 'principal' subsidiaries in the annual report and file a full list with their annual return was removed as part of the UK implementation of the new Accounting Directive. This has resulted in the addition of a significant number of pages in the annual report for many companies – up to 10 for some.

From 1 January 2016, companies will also be required to disclose the addresses of registered offices - this could potentially be a lengthy disclosure for companies with a large number of subsidiaries with registered offices in different locations.

We recommend that as part of the implementation of the non-financial reporting Directive (which amends the Accounting Directive), BIS re-instate the former concession so that the full list can be filed with the annual return, with disclosure of only 'principal' subsidiaries in the annual report. This would be consistent with the materiality principle that underpins the Strategic Report and financial statements. However, where companies are filing the full list with the annual return, we suggest that Companies House has monitoring and enforcement procedures in place to ensure that the list submitted is complete.

### *Electronic reporting*

#### **Electronic Reporting**

##### **Q10) Advantages and Disadvantages**

What do you see as the advantages and disadvantages of preparing or receiving the non-financial statement electronically via a company's website?

##### **Q11) Additional Protections**

Considering your response to Q7, are there any additional protections that the government should consider?

##### **Q12) Number of Companies Providing an Electronic Report**

We are interested in the number of companies that currently send their annual report electronically. Considering your shareholders, how many, as a percentage, opt to receive their annual report as a printed copy.

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<sup>7</sup> See also Schedule 4, Part 1(1) of the Large and Medium sized Companies and Groups (Accounts & Reports) Regulations

**Q10 & 11)** We believe that it is important for regulation to evolve so that it embraces developments in technology and takes into account that many users of annual reports are no longer using the printed document with PDF being the preferred medium of communication<sup>8</sup>.

This presents opportunities for some information to be published outside of the annual report as electronic reporting can improve navigation. See our response to questions 1 and 3 above for our views on publication of the non-financial statement as a separate document. Where information is published separately, we encourage use of signposting from the annual report to complementary information outside that document so that the complete set of related information is readily accessible.

**Q12)** We understand from companies that the Companies Act provisions that provide shareholders with the ability to obtain a hard copy of an annual report are perceived to be a barrier to electronic reporting. Companies have informed us that the costs to produce even one hard copy of the annual report can be significant. In light of the developments in technology and pending outcome of the responses to Q12, we encourage BIS to review the Companies Act provisions (e.g. section 430 requirements on website publication) with a view to eliminating this barrier.

That said we are aware that there may be some users that do not have access to technology and we would encourage companies to facilitate access in these circumstances. For example, many service providers (e.g. mobile phones) only send bills electronically but there is usually an 'opt-in' for customers to receive printed copies.

**Costs**

**Q18) Analysis of the Costs and Benefits of implementing the NFR Directive**

**Q18)** Not applicable

**Additional Comments**

**Q19)** Additional Comments on the Directive

Are there any additional comments that you would wish to make on this Directive

**Q19)** We have no further comments.

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<sup>8</sup> For further information refer to the FRC's Lab Project Report 'Digital Present'. <https://www.frc.org.uk/Our-Work/Publications/Financial-Reporting-Lab/Lab-Project-Report-Digital-Present.pdf>