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The Strategic Report
A practical guide to the new Regulations

Contents

Introduction

In the last decade or so, the length of annual reports has increased substantially, making it progressively more of a challenge for users of those accounts to draw out what is most important.

The new narrative reporting legislation, effective for periods ending on or after 30 September 2013, provides the opportunity for UK companies to take a fresh look at the structure and content of what is commonly termed the 'front half' of the annual report. While the requirement to present a 'strategic report' may not, in itself, represent an enormous change for many quoted companies, the newly extended requirements for such companies may prompt a rethink. Taken together with other new requirements in the 2012 UK Corporate Governance Code, the Directors' Remuneration Regulations and changes to the auditor's report, now is a good time to revisit the structure and content of the annual report.

But there is more to a good strategic report than merely including the new requirements and carrying on. In its 2012 Annual Report, the Financial Reporting Review Panel (FRRP, now the Conduct Committee) commented that a good annual report contains "a single story", showing "how the money is made" in a consistent, clear and uncluttered manner. And what is narrative, after all, if not telling a story? All good stories need to be clearly written and contain a main plot, a consistent narrative thread, a beginning, middle and end.

Of course, most of us are not writers, and achieving real cohesion against a changing legislative and regulatory landscape may be daunting. Nor is there one answer for every company; in fact, at the heart of the new requirements sits the desire to avoid boilerplate, to make narrative reporting more meaningful and insightful.

For those reasons, this publication does not illustrate a 'model' strategic report from start to finish, based on an imaginary company with an imaginary business model, manufacturing imaginary widgets and employing imaginary people. This publication is all about helping you to make the strategic report as valuable for its users as possible, taking into account the different needs of different businesses. As well as providing guidance on the key requirements of the existing and new legislation, it provides useful insights into what those requirements really mean and how they might be best approached in practice.

How to use this document

The next few pages start by putting the strategic report into context with the rest of the annual report, before giving an overview of the components that make up the strategic report and how they link together. This is designed to provoke thought about the structure of both the annual report and strategic report and how they might be moulded into a cohesive document with common threads running throughout.

Thereafter, each of the requirements is examined and explained, with some thoughts and ideas for consideration as to how the requirements can be addressed insightfully and valuably, and how best to link the requirement in with the rest of the report. A checklist for the new statutory requirements is included as an appendix to this publication.

Dark blue bold text within this publication indicates a hyperlink to more guidance or underlying materials.

The legislative requirements

1. What is the background to the new strategic report legislation?

The concept of 'cutting clutter' will by now be familiar to many, with the government and the Financial Reporting Council (FRC) keen to promote annual reports that present information which is genuinely relevant to the company in question and which meets shareholder needs, rather than just meeting the requirements of law and regulation through boilerplate, generic disclosure.

In September 2011, the government consulted on new proposals for narrative reporting, including the idea that companies would produce a strategic report as part of the annual report and a separate annual directors' statement, which could be made available to shareholders on request. Since then, taking into account feedback received, the proposals have been tweaked and softened quite significantly. The **Kay Review of UK Equity Markets and Long-term Decision Making**, published in 2012, reiterated the need to establish a culture of communication and trust between investors and businesses. Finally, in August 2013, Parliament approved **The Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013.**

The Regulations retain the core requirement of their original proposals, namely to prepare a strategic report, but omit a number of the other proposals. The new strategic report is required for all companies other than small companies and, as with the old business review, has specific additional requirements for quoted companies.[1]

These Regulations come into force for periods ending on or after 30 September 2013, alongside a number of other requirements and guidance including **revisions to directors' remuneration reporting, the 2012 UK Corporate Governance Code and related Guidance on Audit Committees** and **the FRC's encouragement to consider the Sharman Principles** when drafting going concern disclosures.

Insight: This means that reporters with financial years ending on, for instance, 29 September 2013, will not have to comply with the new requirements to prepare a strategic report, make the mandatory disclosure on greenhouse gas emissions or follow the new directors' remuneration reporting requirements. This will be particularly relevant to 52-week reporters (depending on how the dates fall). However, the 2012 UK Corporate Governance Code changes apply to periods commencing on or after 1 October 2012 and so may catch such companies depending on when their financial year began.

2. What is in the legislation?

The purpose of the strategic report is to inform shareholders and help them to assess how the directors have performed their duty to promote the success of the company. The directors of all companies, other than those entitled to the small companies exemption, will be required to prepare a strategic report, which is separate to the directors' report and must therefore be separately approved by the board of directors and signed on behalf of the board by a director or secretary of the company. This requirement replaces the previous requirement to include a business review within the directors' report, although many of the requirements for the strategic report are the same as those previously required for the business review. There is an overarching requirement that the strategic report must contain the information that the directors consider to be of strategic importance and which they would otherwise be disclosing in the directors' report.

There are extended requirements for quoted companies. These are indicated in the rest of this publication by an asterisk (*). In addition to the new carbon disclosures discussed further below, quoted companies must now include additional information on the company's business model, strategy, gender split and human rights issues. Appendix 2 to this document explains the impact of the new narrative reporting regulations on unquoted companies and lays out the minimum requirements that must be met in respect of the new strategic report, as well as highlighting some thoughts for better practice.

1 Quoted company – a company whose equity share capital has been included in the official list in accordance with the provisions of Part 6 of the Financial Services and Markets Act 2000; or is officially listed in an EEA State; or is admitted to dealing on either the New York Stock Exchange or the exchange known as NASDAQ [s385 Companies Act 2006]. It does not include companies admitted to trading on AIM.

The option for companies to provide summary financial statements to shareholders has been withdrawn as part of the new Regulations. Instead, companies may provide shareholders with the strategic report, along with 'supplementary material' which will include some administrative particulars, information on the auditor's report and, for quoted companies, the 'single total figure table' for directors' remuneration as required by the new Directors' Remuneration Regulations.

The supplementary material does not have to include any additional financial information, meaning that shareholders will be increasingly reliant on the more narrative-style information provided in the strategic report.

Insight: More detail on the specific requirements of the new narrative reporting Regulations can be found in our recent **Need to Know** and Appendix 1 to this document.

Carbon reporting

The new Regulations also introduce new requirements for quoted companies to report on greenhouse gas emissions as part of the directors' report. This report will be required to contain an annual quantity of emissions, in tonnes of carbon dioxide (CO_2) equivalent, in respect of:

- emissions produced by 'activities for which the company is responsible', including fuel usage; and
- emissions resulting from the purchase of 'electricity, heat or steam cooling' by the company.

Companies must also disclose the method of calculating the amounts disclosed and, going forward, comparative information will be required after the first year. This information may be promoted to the strategic report, if deemed to be 'strategic' in terms of the company's activities.

Insight: The **Deloitte UK Carbon Reporting Survey 'Lip service or leadership?'** looks in more detail at the new requirements for carbon reporting.

Other related amendments

Companies will no longer have to provide the following information in their directors' report:

- their principal activities during the year;
- details of any substantial difference between the market value and book value of interests in land;
- charitable donations; and
- the policy and practice on payment of creditors.

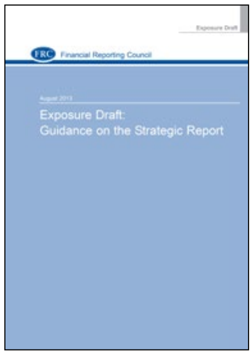
Additionally, private[2] companies will not have to give information on the acquisition of own shares. Quoted companies will no longer have to provide details of essential contractual arrangements (unless of course they are considered relevant for inclusion in the strategic report – perhaps as a principal risk).

Insight: Companies may wish to continue including a description of their principal activities during the year so that a reader of the accounts can understand what the company does. This is of particular relevance to unquoted companies which are not required to describe their business model.

2 Private company – any company that is not a public company as defined by s4 of the Companies Act 2006 (i.e. not a "Plc").

3. What guidance is available?

FRC draft Guidance on the Strategic Report



The Regulations do not amend existing law as much as had originally been anticipated. To promote a 'step change' in the quality of corporate reporting, the Department for Business, Innovation and Skills (BIS) asked the FRC to produce non-mandatory guidance to assist companies in fulfilling the new narrative reporting requirements and encourage companies to publish more relevant narrative reports to facilitate communication and engagement with investors.

In August 2013 the FRC issued its **draft Guidance on the Strategic Report** for consultation. The intention is that it will replace the existing Reporting Statement on the Operating and Financial Review, which ceases to be relevant under the new Regulations. The deadline for comments is 15 November 2013.

This principles-based guidance encourages companies to consider how the strategic report fits within the annual report as a whole. The framework encourages experimentation and innovation with the structure of the annual report and promotes cohesiveness through linkage between the various elements of the annual report.

> **Insight:** The FRC guidance is useful reading as it draws together the vision of the annual report and sets out the elements that have been introduced separately by the FRC and by BIS in one document. The guidance puts the strategic report in context; illustrates how the requirements can be approached; provides examples of how the various elements link together; and provides guidance on determining which disclosure might be material.

The FRC understands that investors want information to be forward-looking and focused on strategy and the business model, highlighting relationships and interdependencies between information presented in different parts of the annual report, with an emphasis on materiality and conciseness.

The guidance builds on the changes made to the UK Corporate Governance Code in October 2012, requiring the directors to confirm that the annual report is fair, balanced and understandable. The guidance is also mindful of developments in integrated reporting, current better practice reporting and other FRC projects. Along with the FRC's project on establishing a framework for disclosure, the guidance aims to 'cut clutter' and improve the relevance of corporate reporting to investors.

The guidance is structured as follows:

Section	Objective
Objectives and scope	Although written with quoted companies in mind, the FRC stresses that it is very relevant to all other companies required to prepare a strategic report.
The annual report	Explains how the narrative report fits into the annual report as a whole. Discusses: • the purpose of the annual report; • the core components of the annual report (being the narrative reports, the corporate governance statement and the financial statements); and • ways of structuring the annual report to facilitate communication.
The narrative reports	Explains the purpose of the narrative reports, which comprise the strategic report and directors' report.
Strategic reports and materiality	Applies materiality to narrative reporting.
The strategic report	Covers: • the purpose of the strategic report; • the communication principles relevant to drafting the strategic report and annual report; and • guidance on approaching each of the content elements required to be included in the strategic report.

Aspects of the draft guidance have been referred to throughout this document.

Deloitte annual survey of annual reports

Deloitte carries out an annual survey of listed company annual reports, which gives a clear view of the current regulatory focus, what is happening in the world of corporate reporting and best practice guidance for annual reports. The 2012 survey 'Joined up writing', and in due course, this year's forthcoming annual reporting survey, are available at www.ukaccountingplus.co.uk.

Fitting the pieces together

4. Where does the strategic report fit into the annual report?

The strategic report is a core element of the full annual report. The draft FRC guidance explains that the annual report should provide shareholders with relevant information which is useful for making resource allocation decisions and assessing management's stewardship. In addition, the guidance splits the structure of the annual report into three separate, though interlinking components – narrative reporting, corporate governance statements and the financial statements.

The components of companies' annual reports will vary, but the annual report – and the links between the various sections – could be envisaged in the following way (although the structure must be appropriate for the company):

Section of annual report	Description of section
Summary/highlights	An introduction to the company's business model, KPIs and achievements in the year
Chairman's statement	How he/she is running the board and effectiveness in achieving the company's strategy and objectives
Strategic report	The business model, strategy, objectives and principal risks, a review of the year and future outlook
Corporate governance statement	How the board and committees are run to provide oversight and strategic direction
Directors' report	Basic legal information
Directors' remuneration report	How the directors will be remunerated in future and how they were paid last year
Directors' responsibility statement	Directors' formal statement that they have prepared what is required of them
Auditor's report	Auditor's report on the financial statements and other matters
Financial statements	Information on financial position and performance

Linkages between the components shown above are discussed in detail later in this document.

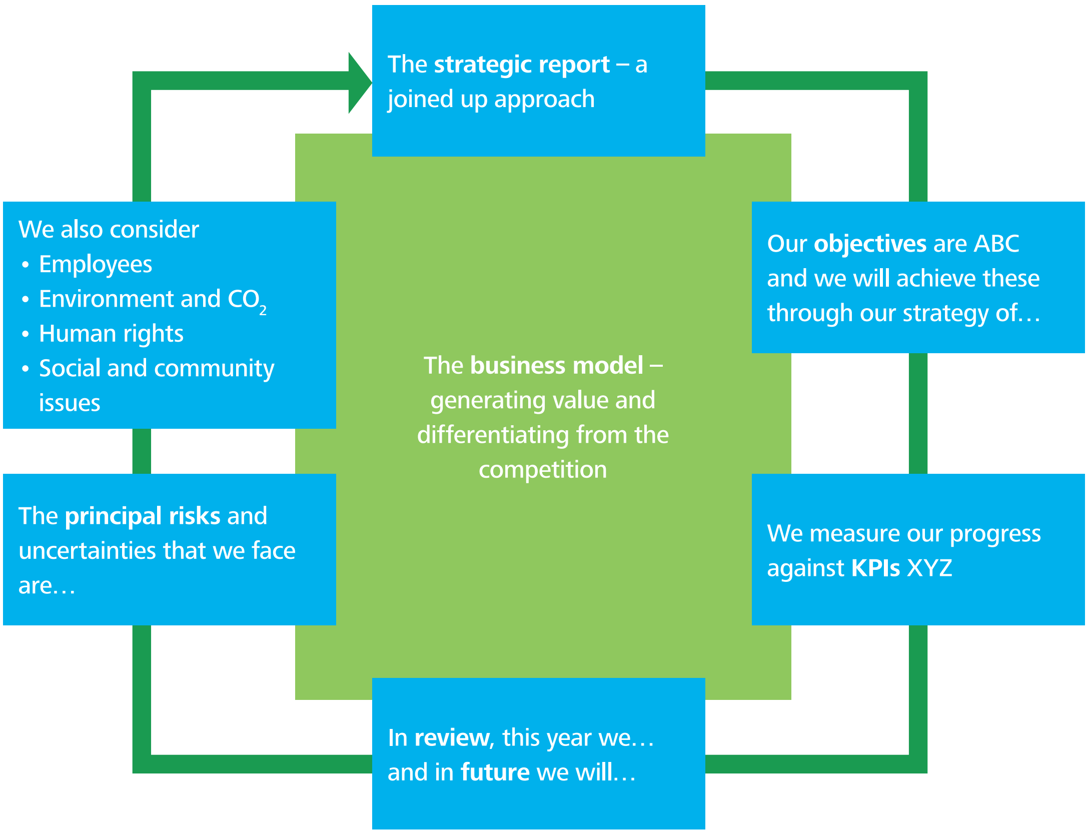
Many companies include a 'summary' section at the start of the annual report which presents highlights of the year, a short introduction to the company and other basic information. This type of summary section can be used as an opportunity to provide users with a link to the new strategic report. The highlight figures could link to where there is further information on the key performance indicators (KPIs – see p16 for detailed consideration of these). The introduction to the business could link to the business model, strategy and objectives, as well as to a full review of the year and future prospects.

Linkage is important not only within the strategic report but throughout the whole annual report. Some ideas as to how a company could demonstrate linkages between the various components (as illustrated above) of the report are as follows:

- visual representation at the front of the annual report (such as a storyboard or diagram) with cross-references to further detail;
- colour-coding of various sections in the report to indicate what each section represents;
- use of symbols to represent certain linkages and a key at the front of the report; or
- simple use of detailed cross-references from and to each section, and from the strategic report to locations elsewhere in the annual report which contain more detail (for instance, including highlights of corporate and social responsibility in the strategic report and cross-referring to a more detailed report).

5. What is the purpose of the strategic report?

The new strategic report brings together all of the most relevant information for shareholders in a cohesive, clear manner – a 'joined up story'. It provides context to the financial statements, an analysis of past performance and insight into the main objectives, strategies, risks – and how these might impact future performance. Identifying the requirements and understanding how they link together will help to give an overall structure to the strategic report. The diagram below is not intended to be prescriptive, but gives a flavour of how the various components of the new Regulations might fit together and how they are linked.



The strategic report needs to contain only that information which is thought to be most relevant to shareholders but also to other important stakeholders. If something is not considered to meet that requirement, the draft FRC guidance states it should not be in the strategic report (unless specifically required by law).

Since the strategic report may be provided to shareholders in place of the full annual report under the new Regulations, ideally it should be readable as a standalone document. Companies may choose to cross-refer to locations elsewhere in the annual report which contain more detailed information (such as a detailed corporate social responsibility (CSR) report). However, it must be made clear whether the material cross-referred to forms part of the strategic report or just provides additional information going beyond that required by law in the strategic report. If such information forms part of the strategic report, the sections cross-referred to would need to be provided to shareholders as well.

6. What is the best approach to restructuring the annual report?

Along with the requirements of the new UK Corporate Governance Code and the revised remuneration report, the new Regulations mean that every company will need to restructure their annual report to some extent. At a minimum, the annual report will need to include a separate strategic report and directors' report – both approved by the board of directors and signed on their behalf by a director or the secretary of the company. Although much of the content of the strategic report may be familiar, it will need to include the additional requirements, as highlighted within the framework set out in this document.

However, given the number of new requirements, now is an ideal opportunity to revisit the structure of the 'front half' of the annual report as a whole.

Insight: Think ahead about the following questions: How is the production of the annual report currently approached? Does that process need to change to incorporate the new requirements of the strategic report? Is there time in the timetable for the board to look at the annual report as a whole and consider whether it is fair, balanced and understandable?

One way of planning for and approaching this may be as follows:

1) Involve in the process everyone who contributes to the annual report, to achieve a cohesive outcome and establish a timeframe for completion e.g. CFO, company secretary, investor relations, sustainability team etc.

Insight: For a cohesive outcome, there needs to be communication between contributors as the report is being developed, starting from the key messages/themes the company wants to run through the report.

2) Create a storyboard identifying all of the components that need to go into the front half of the annual report.

Insight: Consider a 'core and supplementary' approach, where core information goes into the strategic report while information that is less relevant, or that does not change year-on-year, is shown elsewhere, creating a shorter and more focused strategic report. Consider whether information not required by law or regulation could be published on the company's website instead of being included within the annual report.

3) Identify the links between each of the components, decide how those links will be best demonstrated in the report and how each component would be best represented.

Insight: Where companies currently preparing a number of separate statements (e.g. Chairman's Statement, CEO's Statement, Financial Review and Operational Review) is there overlapping content which can be removed or rationalised? Are the reports consistent and free of contradictions? Could the statements be combined, with an introduction from the Chairman and/or CEO to demonstrate ownership?

4) Consider the ordering of the components within the front half of the annual report, and the ordering of the components that go into the strategic report.

Insight: The best order for presenting sections of the strategic report will depend on the company in question. It may be logical to start with the business model and work from there, identifying the key components of the business model and focusing on these in the report. Another approach could be to identify the segments of the business and focus on the segments which are most essential to the business's position and performance.

5) Identify who will take responsibility for each component and who will take responsibility for ensuring overall cohesiveness.

Insight: Once the strategic report has been developed, consider asking someone who has not been involved in the preparation to read the report and assess how well it links together, whether there is overlap or repetition that could be removed, where there are boilerplate disclosures which could be made more insightful and whether the annual report as a whole is fair, balanced and understandable.

7. How should the strategic report be written?

The FRC's draft guidance on the strategic report includes a number of communication principles, which can apply equally to the annual report as a whole:

The strategic report, as a whole, should:

- **be fair, balanced and understandable** (see the section on 'review of the business' below for further discussion of what this means);
- be concise;
- have a forward-looking orientation, where appropriate;
- provide information that is entity-specific;
- highlight relationships and interdependencies (linkages) between information presented in different parts of the annual report; and
- be reviewed annually to ensure that it continues to meet its objectives.

Importantly, the strategic report should be written in plain, clear language that users will be able to understand easily:

• expand acronyms the first time they are used (or a glossary could be provided);

• define any adjusted figures and reconcile them clearly to the financial statements;

• avoid jargon; and

• use concise sentences.

Avoid boilerplate disclosures. There is no value in generic, bland comments that mean little to shareholders and say little about the business. Consider going through your company's last annual report and highlight any sentences which are generic. How much more concise and relevant could the strategic report be without those sentences? How could those sentences be changed to say something which really adds insight?

The FRC's draft guidance highlights the importance of the consideration of materiality within the strategic report. Information should be considered to be material, and therefore included within the strategic report, if the omission or misrepresentation of such information might reasonably be expected to influence the decisions shareholders would make on the basis of the annual report as a whole.

8. How does the strategic report impact on half-yearly reporting?

Companies and groups that are admitted to trading on a regulated market are required to prepare an interim or half-yearly report including an Interim Management Report (IMR), in accordance with the FCA's Disclosure and Transparency Rules (DTR). The new Regulations do not change this and introduce no new requirements for this report. The IMR is not a strategic report as defined in law and it would not seem appropriate to change the name of the IMR.

However, if at the interim management is aware of a change to the business that will appear in the strategic report at the year-end, such as a change in the business model or in the principal risks and uncertainties faced by the business, the interim report could be a useful place to highlight such changes from the last strategic report (in addition to disclosing those principal risks and uncertainties that will apply to the second half of the year, as required by DTR 4.2).

The strategic report – a framework and guide

In the interests of avoiding boilerplate, we set out below a suggested framework for the strategic report which can be followed to create a strategic report which is bespoke and fits the company's circumstances and events arising during the reporting year. The requirements should be addressed in order that is most conducive to telling the company story. For more detailed guidance, refer to the FRC's draft **Guidance on the Strategic Report.**

Strategy and objectives

NEW

Reference/s	Requirement (* = quoted companies only)
CA06 s414C(8)(a)	*Include a description of the company's strategy.

> **Insight**: Strategies and objectives change over time and the reporting of these should be revisited each year to assess whether or not the stated objectives truly reflect the changing business and fit clearly into the business model.

The objectives, strategy and business model of a company set the context for other disclosures in the annual report. The disclosed objectives should be the primary goals that the company wants to achieve. The 'strategy' is the overall 'plan of action' that is designed by management to achieve the company's objectives. Although not specifically required by law, the FRC's draft guidance encourages disclosure of objectives as they are integral to a discussion of the company's strategy and business model. In practice the level of detail included is likely to vary depending on the complexity of the company's operations.

Key considerations

Consideration	How this might be implemented
Are objectives clearly defined and explained?	• Clearly state the main financial and non-financial objectives of the business. • It may be helpful to make objectives measurable, perhaps by cross-referring to KPIs. • Objectives might be split into short, medium and long-term goals.
Is the strategy for meeting objectives sufficiently detailed?	• Depending on the complexity of the business, the strategy might include: – a summary of actions taken to date and their outcomes; – future planned actions over the short, medium and long-term; – consideration of the capital/financing required to achieve objectives; and – a summary of the risks inherent in the strategy and a cross-reference to the related principal risks and uncertainties. • Discuss how the business intends to achieve its objectives in the context of the market outlook.

Strategy and objectives:	
Business model	– How does the business plan to achieve its objectives?
KPIs	– Is progress on objectives and strategy measurable by reference to KPIs?
Principal risks and uncertainties	– What are the key risks to the strategy?
Directors' remuneration	– How does remuneration support the short and long-term strategic objectives?

The business model

Reference/s	Requirement (* = quoted companies only)
CA06 s414C(8)(b)	*Include a description of the company's business model.

NEW

The requirement to explain the business model was a relatively recent addition to the UK Corporate Governance Code, but is now a legal requirement (rather than comply or explain) under the new Regulations. A good strategic report uses the business model to link to all of the components in the report. This can be considered the key to cohesion, as the business model picks up on almost every aspect of the requirements for the strategic report.

Insight: The business model can be shown in any format. Consider what best suits the business, bearing in mind the overall goal of demonstrating how the business creates value for shareholders. Visual representations can have more impact than long blocks of text.

Key considerations

Consideration	How this might be implemented
What does my business model need to include?	• Consider the following questions in describing the business model: – Who are we? – What do we do? – Where are we based? – What market do we operate in? – What do we sell? – What is our unique selling point (USP)? – How does the business operate? – How do we generate value for shareholders over the long and short term? – How do we measure our success? – What makes us different to our peers? • Other questions may also be relevant, depending on the company: – How do we identify and manage our risks? – What capital do we need to run our business? – What are our key resources? – How is the business sustainable? – What do we do for our other stakeholders?
How is my business model best represented?	• There is no prescriptive format, meaning that the business model can be presented in various ways; a tabular format, visual representation or simply narrative may be most appropriate.
Am I making best use of the business model section?	• This section can be used as the central reference point for the rest of the strategic report. • Cross-refer relevant points to where further detail can be found on each point covered. For instance: – objectives, strategy, KPIs, risks, CSR and going concern might all be referred to in the business model with a cross-reference to a more detailed discussion elsewhere.

Insight: The Deloitte publication **'Governance in focus: describing your business model and strategy'** provides a detailed framework for describing a business' strategy and business model.

The business model links to:	
Strategy and obectives	– What is the business model intended to achieve?
KPIs	– How is the effectiveness of the business model measured?
Review of the business	– How successful has the business model been?
Principal risks and uncertainties	– What is the risk that the business model is not sustainable in the future?

A fair review of the business

Reference/s	Requirement (* = quoted companies only)
CA06 s414C(2)(a), (3)	Provide a fair review of the company's business. The review required is a balanced and comprehensive analysis of the company's development and performance during the year and the position at the end of that year. It should be consistent with the size and complexity of the business.

The level of detail and length of the review will vary significantly depending on the size of the business under review. A small company with straightforward activities and no unusual events in the year is likely to have a very short review, while a large group with complex operations in a number of markets or industries would need to provide a more extensive review.

Insight: If 60% of the business's profit derives from one segment and the business is considered to have three segments, it might be appropriate for that segment to be discussed in more detail than the other segments, in proportion to its strategic significance for the business as a whole.

The review of the business can be made particularly meaningful by relation to objectives and specific KPIs. It also links in neatly with the requirement to consider future developments (see overleaf) and these two requirements could be subsumed within the same part of the report.

Key considerations

Consideration	How this might be implemented
What might the business review discuss?	• Does the review contain the most relevant information (rather than being an information 'dump' of everything that has happened, whether significant or not)? • Consider discussing: – the profitability of the business in the year, commenting on specific events which had an impact on profit or loss; – the cash position of the business, discussing significant in- and outflows during the year; – the financial position at the year-end, including consideration of liquidity and solvency (which may in turn link to risk management and the going concern assumption); – progress and events in areas that are not necessarily reflected in the financial statements, such as commercial developments (perhaps by segment or operation), research and development, business development and CSR-type considerations; and – any other key events which have taken place in the year which have had an effect on the business.
Is the review fair, balanced and understandable?	• Does it cover both financial and non-financial performance and position? • Are both positive and negative events and issues covered in a balanced fashion? • Is there evidence of linkage (i.e. front to back half) and between components? • Is there balance between GAAP and non-GAAP measures? • Does it reflect discussions of the board? • Is the annual report consistent with previously communicated objectives and KPIs? • Is this consistent with investor presentations? • Is the review written in clear and plain English? – Avoid use of jargon and acronyms – or at least define terms used. – Where "underlying" or "adjusted" figures are discussed, explain what these mean and how they have been calculated so that users can understand them.

Insight: The requirement in the 2012 UK Corporate Governance Code is for the annual report to be fair, balanced and understandable, as a whole. The FRC draft guidance suggests that the strategic report itself should also be fair, balanced and understandable. It may be that some elements of the annual report may not be fair, balanced and understandable when taken on their own but when considered as a whole, annual report meets the requirement.

The review of the business links to:	
Strategy	– How has the business positioned itself over the year?
Objectives and KPIs	– How has the business performed against these?
Business model	– Is the business model presented consistent with the business activities in the year?
Principal risks and uncertainties	– How have these affected performance?
Going concern	– Have the year's events affected the assessment?

Future developments

Reference/s	Requirement (* = quoted companies only)
CA06 s414C(7)(a)	*To the extent necessary for an understanding of the business, discuss the main trends and factors likely to affect the future development, performance and position of the company's business.

Key considerations

Consideration	How this might be implemented
How can future developments be discussed meaningfully?	• "Future" can mean short-, mid- and/or long-term; consider whether it will be useful to users to clarify the timeframes being considered where future developments are discussed. • Where events are already known and expected to occur, be specific in discussing them; generic boilerplate about the 'current economic uncertainty' having some unspecified, unquantifiable impact is not useful to users. • Include enough detail to enable shareholders to have a good understanding of what the future events and impacts may be. • Put future developments in context; where will the most significant impacts be felt, and what might the extent of those impacts be on the business's KPIs and objectives? • Consider both internal and external factors which could affect the business. • Consider addressing this requirement as part of the business review by linking past performance to future developments.

The discussion of future developments links to:	
Review of the business	– Having covered what's happened, what's around the corner?
Strategy	– What will affect the strategy in the next year?
Objectives	– How will the business progress its objectives?
KPIs	– What is the target for next year's KPIs?
Principal risks and uncertainties	– Will the company face new/changed risks?

Key performance indicators

Reference/s	Requirement (* = quoted companies only)
CA06 s414C(4)	To the extent necessary for an understanding of the development, performance or position of the company, include analysis using financial and, where appropriate, non-financial key performance indicators.

‘Key’ performance indicators (KPIs) should be the measures that are used by management in determining how well the company is performing against its objectives and its overall strategy. A KPI is defined in law as a factor by reference to which the development, performance or position of the company’s business can be measured effectively.

Insight: Companies frequently include ‘highlights’ in a summary section at the front of the annual report. Often these measures differ to the KPIs identified elsewhere. It might be reasonably expected that KPIs would be given upfront in the annual report if they are genuinely the key measures of performance that are most relevant to the company.

The Regulations require both financial and, where appropriate, non-financial KPIs to be given. Non-financial KPIs might include environmental, health and safety or customer service measures. Although the proportion of KPIs that are non-financial is wholly dependent on the company in question, in most cases there are some non-financial measures which a business uses.

The Regulations require analysis, as well as presentation, of KPIs. Some considerations as to how this might be done are discussed further below.

Key considerations

Consideration	How this might be implemented
Are KPIs clearly identified?	• While the Regulations do use the term ‘key performance indicators’, use of this term is not mandated for the strategic report. However, it is a commonly used and understood term which does help users to identify the measures which are considered by directors to meet the definition of a KPI.
How many KPIs are identified?	• The number of KPIs will clearly vary depending on the company size, business model and industry, among other factors. • Too many KPIs may lead users to question whether or not all of the measures listed are genuinely ‘key’.
Is it clear why the KPIs are considered ‘key’?	• Explain why each KPI has been selected by management to represent a measure of the company’s performance and position.
Are KPIs linked to the strategy and objectives of the company?	• The KPIs could be incorporated in the business model disclosure, or directly linked to particular objectives, with a cross-reference to the section of the report which focuses on KPIs in more depth.
Is there enough supporting information about the KPIs for the user to put them in context?	• Comparatives can be helpful in illustrating a trend of past performance and development. • A future target for each KPI helps to relate current performance to the company’s future goals. • Where KPIs are calculated from other financial results (e.g. Return on Capital Employed), give (or cross-refer to) the calculation and any reconciliations to the financial statements so that the numbers can be easily traced. • State the source of any KPIs – for example, employee engagement may be given based on a formal survey performed during the year. • Explain movements in KPIs over time, both favourable and adverse.

KPIs can be linked to:	
Strategy and objectives	– How do KPIs help measure progress?
Business model	– How can shareholders see value being generated?
Review of the business	– Is the business performing well against its KPIs?
Future developments	– What targets have been set for KPIs going forward?
Directors' remuneration	– How does remuneration relate to KPIs?

Principal risks and uncertainties

Reference/s	Requirement (* = quoted companies only)
CA06 s414C(2)(b)	Describe the principal risks and uncertainties facing the company.

The requirement to describe the principal risks and uncertainties facing the business has long been an area of challenge for companies. In its 2012 Annual Report, the FRRP (now the Conduct Committee) reiterated its concern that companies need to ensure that they are genuinely describing the principal risks and uncertainties that they face, and not all possible risks.

It goes on to explain that, in a good annual report, *"The descriptions are sufficiently specific that the reader can understand why they are important to the company. The business review also describes the mitigating actions taken by the Board to manage the impact of its principal risk and uncertainties. The links to accounting estimates and judgements are clear."* The Conduct Committee intends to continue to challenge companies that provide boiler-plate disclosures around their principal risks and uncertainties.

Insight: This area has long been and will continue to be an area of focus and scrutiny by regulators. Risks evolve and change frequently and better reports use this section of the strategic report not only to show the current principal risks but also to demonstrate how the company's risk profile has changed over time.

This is not an area where "more is better". It is critical to draw out only those risks which are genuinely key, and focus on providing specific, detailed information about those risks. A tabular format like the one following may be useful:

Risk	Impact on company	Assessment of change in risk year-on-year	Mitigation of risk
<insert risk here>	*<Describe the specific impact/s that this risk may have and explain why the risk is so critical to the company>*	*<Explain whether this risk has become more or less critical compared to the previous year and why. Consider whether this risk is likely to become more significant still in the coming year/s>*	*<State what measures are in place to reduce the potential impact and likelihood of this risk affecting the business. Explain any future plans to amend or enhance those measures>*

A visual illustration of risk may also be useful, and some businesses present a 'risk map' which categorise the principal risks by probability of occurrence and severity of impact. This section can be linked easily to the discussion of internal controls and risk management, which usually sits within the corporate governance section of the annual report.

Key considerations

Consideration	How this might be implemented
How many risks are identified?	• The number of principal risks identified is likely to vary based on the business in question. Only include those that 'keep the board awake at night'.
Are the risks genuinely 'principal'?	• If a user was to read through the list of risks would they have a fair understanding of the risk profile of the company in the context of the remainder of the strategic report?
Are the risks specific to the company?	• Although certain 'wide scope' risks (such as the 'uncertain economic environment') can affect almost every company, it is important to make the discussion of such risks clearly relevant to the business in question and avoid boilerplate. If something has been listed as a risk, it must be clear what the impact would be on that particular business. • This could be achieved by identifying the segments that would be affected and explaining what the potential impact could be. • It is important to explain how the risks are mitigated.
How has the risk profile of the company changed over the year?	• Identify the risks that are new in the year and explain why they have been 'promoted' to being principal risks. • Explain why any risks that have been dropped from the list are no longer considered 'principal'. • Consider risk management processes in response to the changing risk environment. • Consider stress tests and other tests of sensitivity.

Principal risks and uncertainties can be linked to:	
Strategy	– What could go wrong with the strategy?
Business model	– How resilient is the business model?
Corporate governance statement	– What is the board process for identifying and managing risks?
Financial statements	– Are the financial risks discussed considered key?

Corporate and social responsibility

Reference/s	Requirement (* = quoted companies only)
CA06 s414C (7)	* To the extent necessary for an understanding of the business, provide information on: (i) environmental matters (including the impact of the company's business on the environment), (ii) the company's employees, and (iii) social, community and human rights issues. NEW This should include information about any policies in relation to those matters and the effectiveness of those policies. If any of these are not covered, the company should explain why.
CA06 s414C(8)(c)	* A quoted company must give a breakdown of the following as at the end of the financial year: NEW (i) the number of persons of each sex who were directors of the company; (ii) the number of persons of each sex who were senior managers of the company (other than those included above) and (iii) the number of persons of each sex who were employees of the company.

Quoted companies have long been required to include information on environmental, employee and social/community issues. Under the new Regulations, quoted companies will also need to discuss their approach to human rights issues, and provide further disclosure around the gender split of the company.

Disclosure is only necessary to the extent required for an understanding of the development, position and performance of the company, so the extent of information given will depend on the degree of relevance to the company. However, if any of the areas are not covered, the company needs to explain why it was not covered. Companies would need to consider how investors and other users of the annual report may respond in this scenario.

Insight: If your company publishes a separate Corporate and Social Responsibility or Sustainability Report, cross-referencing and/or providing a link to this report may be useful, but by itself is not sufficient to meet the requirements of the Regulations; information must still be provided in the annual report itself.

Key considerations

Consideration	How this might be implemented
How might these requirements be presented?	• Many quoted companies already prepare a "Corporate and Social Responsibility" report which is either presented as part of the business review or cross-referred to from the directors' report.
How should the new disclosure on human rights be approached?	• Identify specific considerations rather than making a boiler-plate statement that the company is committed to good practice in respect of human rights. • In developing this disclosure, companies might consider: – how they select suppliers and ensure their supply chain is ethically sound (particularly where companies use overseas suppliers); – how any overseas operations are overseen and supervised to ensure human rights are protected; – the effect of operations on the wider population; – detail around any additional protection afforded to employees to ensure their rights are upheld; and – any equal opportunity policies and how they are implemented. • The UN Rights Council **Guiding Principles on Business and Human Rights: Implementing the United Nations 'Protect, Respect and Remedy' Framework**, particularly section II, which outlines what business should do to respect people's human rights, may be a good source of reference.
What does the new gender split disclosure require?	• The gender split disclosure is also a new requirement, although some companies have already introduced similar disclosures. • The idea behind this requirement is that shareholders can gain some visibility over the number of employees of each gender who may, in the future, become senior managers and, in turn, directors. • The first of the disclosures is reasonably straightforward as it is the directors of the parent company only (i.e. the main board). • The definition of a senior manager in law is potentially more of a grey area. The law defines a senior manager as "an employee who is a director of a subsidiary of the company or who otherwise has responsibility for planning, directing or controlling the activities of the entity or a strategically significant part of it". The disclosure is in respect of the group so is likely to include directors of entities included within the consolidation (excluding the parent company). • The total employees split is also to be determined on a consolidated basis. • The disclosure required is the total numbers, not proportions or percentages. • For companies complying with the **UK Corporate Governance Code**, disclosures around the gender split could also make reference to the disclosures made in accordance with Code provision B.2.4 around the board's policy on gender diversity, objectives in this area and progress on those objectives.

Corporate and social responsibility can be linked to:	
Strategy	– How does CSR fit into the strategy and objectives?
Principal risks and uncertainties	– What risks relate to CSR activities?
KPIs	– Which KPIs are CSR-related and why?
Governance	– What is the board's policy on diversity (including gender)?
	– What are the board's objectives for implementing that policy?
	– What progress has been made towards meeting those objectives?

Carbon reporting – directors' report

Reference/s	Requirement (* = quoted companies only)
Part 7 of Schedule 7 to SI 2008/410 (as inserted by Regulation 7 of SI 2013/1970)	*State the annual quantity of emissions in tonnes of CO_2 equivalent from activities for which the company is responsible. This should include the combustion of fuel and the operation of facilities. *State the annual quantity of emissions in tonnes of CO_2 equivalent resulting from the purchase of electricity, heat, steam or cooling by the company for its own use. *Explain the methodology used to calculate the above figures. *If it is not practical for the company to give the information above, state what information is included and why. *Give at least one ratio which expresses the quoted company's annual emissions in relation to a quantifiable factor associated with the company's activities. *After the first year to which these requirements apply, comparatives must be given.

The new Regulations include requirements for quoted companies to make certain disclosures about their carbon emissions in the directors' report. This includes both direct emissions – those for which the company is responsible – and indirect emissions, representing those arising from the purchase of energy. If carbon reporting is of strategic significance to the company, the disclosure should be promoted from the directors' report to the strategic report. This is likely to be the case for electricity generation companies or other heavy industrial businesses.

The quantity disclosed also needs to be put into context of the company by presenting total annual emissions as a ratio in relation to a factor which is relevant to the company's activities. The factor selected will depend on what the business is and is at the discretion of management to choose. For instance, a company generating most of its emissions from revenue-generating activities may find it most relevant to express emissions in tonnes of CO_2 per £1m of total revenue. A research and development (R&D) company may find it more relevant to present emissions against total R&D expenditure for the year. More than one such ratio could be presented.

Insight: The **Deloitte UK Carbon Reporting Survey 'Lip service or leadership?'** contains a wealth of information and insight into how companies are reporting carbon emissions and includes good practice examples.

Key considerations

Some companies prepare a CSR report within their annual report. The strategic report must include information of an environmental nature while carbon reporting disclosures may be given in the directors' report. In the interests of keeping the related information in the same place as far as possible, companies may choose to cross-refer to their CSR report from their directors' report and strategic report, or to promote the carbon reporting disclosures to the strategic report.

Many companies may not collect the data required by this part of the Regulations as yet, which may make complying difficult if not impossible. The regulations do allow for this, confirming that the disclosure does not have to be made where it is not practical for the company to obtain the information. This might be most relevant for companies that rent out office buildings, for instance, where they may not have access to those buildings to obtain the energy usage data. However, where disclosures are not made, the company must state what those are and explain why they have not been made.

Appendix 1: Summary of requirements

The strategic report – a summary of the legislative requirements

Reference	Requirement (* = quoted companies only)	Complied?	More information on page
CA06 s414A(1), (2) CA06 s414B	The directors of a company must prepare a strategic report for each financial year of the company, unless the company is entitled to the small companies' exemption. A company is entitled to the small companies' exemption in relation to the strategic report if it is entitled to apply the small companies' regime, or if it would be so entitled but is a member of an ineligible group.		3
CA06 s414A (3)	Where the company is a parent company and group accounts are prepared, the strategic report must be a consolidated report (a "group strategic report") relating to the undertakings included in the consolidation.		3
CA06 s414A (4)	A group strategic report may, where appropriate, give greater emphasis to the matters that are significant to the undertakings included in the consolidation, taken as a whole.		3
CA06 s414C(1)	The purpose of the strategic report is to inform members of the company and help them assess how the directors have performed their duty under section 172 (duty to promote the success of the company).		3
CA06 s414C(2)(a), (3) DTR 4.1.8 Code C.1	Provide a fair review of the company's business. The review required is a balanced and comprehensive analysis of the company's development and performance during the year and the position at the end of that year. It should be consistent with the size and complexity of the business. The board should present a fair, balanced and understandable assessment of the company's position and prospects.		14
CA06 s414C(2)(b) DTR 4.1.8	Describe the principal risks and uncertainties facing the company.		18
CA06 s414C(4), (6) DTR 4.1.9	Analyse the company's performance and position using financial and, where appropriate, non-financial key performance indicators, including information relating to environmental and employee matters. Medium-sized companies do not need to provide non-financial KPIs.		16
CA06 s414C(7)(a) DTR 4.1.11	*Discuss the main trends and factors likely to affect the future development, performance or position of the company's business.		16
CA06 s414C(7)(b)	*Provide information on: (i) environmental matters (including the impact of the company's business on the environment), (ii) the company's employees, and (iii) social, community and human rights issues. This should include information about any policies in relation to those matters and the effectiveness of those policies. If any of these are not covered, the company should explain why.		20
CA06 s414C 8(a) Code C.1.2	*Include a description of the company's strategy. The directors should include in the annual report … the strategy for delivering the objectives of the company.		12
CA06 s414C 8(b) Code C.1.2	*Give a description of the company's business model. The directors should include in the annual report an explanation of the basis on which the company generates or preserves value over the longer term (the business model).		13

Reference	Requirement (* = quoted companies only)	Complied	More information on page
CA06 s414C (8) (c), (10)	*Give a breakdown of the following as at the end of the financial year: (i) the number of persons of each sex who were directors of the company (or parent company, for a group strategic report); (ii) the number of persons of each sex who were senior managers of the company (*excluding* those in (i) above, but *including* directors of any subsidiary undertakings in the group) and (iii) the number of persons of each sex who were employees of the company.		20
CA06 s414C (11)	The strategic report may also contain such of the matters otherwise required by regulations made under section 416(4) to be disclosed in the directors' report as the directors consider are of strategic importance to the company.		3
CA06 s414C (12)	The report must, where appropriate, include references to, and additional explanations of, amounts included in the company's annual accounts.		7
CA06 s414C (14)	Disclosure of information about impending developments or matters in the course of negotiation is not required if the disclosure would, in the opinion of the directors, be seriously prejudicial to the interests of the company.		N/A
CA06 s414D (1)	The strategic report must be approved by the board of directors and signed on behalf of the board by a director or the secretary of the company.		N/A
Acc Regs. Sch 7:1A	Where a company has chosen in accordance with section 414C(11) to set out in the company's strategic report information required by this Schedule to be contained in the directors' report it shall state in the directors' report that it has done so and in respect of which information it has done so.		N/A

Notes

CA06 refers to The Companies Act 2006.

Code C.1.3 refers to the 2012 UK Corporate Governance Code issued by the Financial Reporting Council.

DTR 4.1.8 refers to the Disclosure and Transparency Rules of the Financial Conduct Authority.

New or significantly amended requirements have been highlighted in red text above.

In addition to this checklist, please refer to the FRC's draft Guidance on the Strategic Report, which is discussed earlier in this publication. At time of writing this guidance was available in draft form only and as such has not been incorporated into the checklist.

Carbon reporting – a summary of the legislative requirements for quoted companies

Reference	Requirement	Complied?
Acc Regs. Sch 7:15(2)	State the annual quantity of emissions in tonnes of CO_2 equivalent from activities for which the company is responsible. This should include the combustion of fuel and the operation of facilities.	
Acc Regs. Sch 7:15(3)	State the annual quantity of emissions in tonnes of CO_2 equivalent resulting from the purchase of electricity, heat, steam or cooling by the company for its own use.	
Acc Regs. Sch 7:15(4)	If it is not practical for the company to give the information above, state what information is included and why.	
Acc Regs. Sch 7:16	Explain the methodology used to calculate the above figures.	
Acc Regs. Sch 7:17	Give at least one ratio which expresses the quoted company's annual emissions in relation to a quantifiable factor associated with the company's activities.	
Acc Regs. Sch 7:18	After the first year to which these requirements apply, comparatives must be given.	
Acc Regs. Sch 7:19	The directors' report must state if the period for which it is reporting the information required by paragraph 15(2) and (3) is different to the period in respect of which the directors' report is prepared.	

Acc Regs. Sch 7 refers to Schedule 7 of the Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410), as amended by the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013 (SI 2013/1970).

Cutting clutter – a summary of the requirements that have been removed from law

The following requirements have been removed from the law. Consider whether to remove them unless, in the directors' judgement, they are needed for a fair review of the business (in which case, consider whether to include them in the strategic report).

Disclosure that may be removed from the directors' report	Removed?
Description of the principal activities of the company during the course of the year	
Policy and practice on payment of creditors	
Quoted companies only – disclosure of essential contractual arrangements	
†Disclosure of charitable donations made	
†Private companies only – disclosure of the acquisition of own shares	

†Requirements previously applied to small companies also and may be removed from the directors' reports of small companies under the new Regulations.

Appendix 2: Unquoted companies

Introduction

In August 2013, parliament approved **The Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013**. These Regulations, which amend the Companies Act 2006, apply to all companies **except those qualifying as small**, although certain requirements within the Regulations only apply to quoted companies. This Appendix provides a step-by-step guide for unquoted companies to ensure compliance with the new Regulations as well as some suggestions for better practice. A summary of the requirements is given overleaf.

What changes are required to comply with the new Regulations?

The requirement to include a business review within the directors' report has been replaced with the requirement to prepare a 'strategic report'. Unlike the business review, the strategic report must be presented separately to the directors' report. It must also be separately approved by the board of directors and signed on behalf of the board by a director or the secretary of the company.

To comply with the Regulations, the section within the directors' report which is currently titled 'business review' should therefore be removed from the directors' report and presented separately. References to the 'business review' should be replaced with references to the 'strategic report'. Both the new strategic report and the directors' report should be signed separately on behalf of the board.

For unquoted companies, the contents of the strategic report will mirror those previously required for the business review. They should therefore require little or no further change.

What disclosures can be removed under the new Regulations?

Unless considered relevant to the strategy of the business, unquoted companies can remove the following disclosures from the directors' report:

- the description of the principal activities of the company during the course of the year;
- asset values, i.e. the difference between the value of land as noted in the balance sheet and the directors' view of the value of that land;
- charitable donations;
- the policy and practice on payment of creditors; and
- disclosure of the acquisition of own shares.

Some thoughts for better practice

The procedures above will enable basic compliance with the requirements of the Regulations. However, companies wishing to enhance their narrative reporting further might consider doing one or more of the following in their strategic report:

- including a description of the business model of the company and how it generates value for shareholders;
- explaining why KPIs are selected and how they relate to the measurement of progress against the company's objectives; or
- discussing how future developments might impact the position and performance of the company – perhaps by cross-reference to any going concern disclosures in the notes to the financial statements.

Further resources and information

Further information on the new legislation as well as the Deloitte publications listed below and other UK accounting, reporting and corporate governance news can be found on **www.ukaccountingplus.co.uk.**

Need to Know: New UK narrative reporting regulations laid before parliament – this publication explains the key requirements of the new Regulations.

Joined up writing – surveying annual reports – Deloitte's comprehensive survey of annual reporting.

UK Carbon Reporting Survey: Lip Service or Leadership? – Deloitte's survey of current practice in carbon reporting in the UK, including better practice examples.

The FRC's draft Guidance on Strategic Reports is available from the FRC website: **www.frc.org.uk**

The full Regulations can be found at **http://www.legislation.gov.uk/uksi/2013/1970/contents/made**.

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Notes

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