

# ***The non-financial reporting regulations***

What do they mean  
in practice?

July 2017

## Background and context

For periods beginning on or after 1 January 2017 Public Interest Entities with over 500 employees will be required to include a non-financial information statement in their strategic report. The new regulations<sup>1</sup> that give rise to this were driven by an EU directive to harmonise non-financial reporting across member states and, given the apparent similarity to the existing strategic report regulations<sup>2</sup>, it wouldn't be surprising if this has been below the radar of many UK companies so far.

However, the requirements differ in a number of ways from the strategic report regulations and companies are now implementing them in the context of some far-reaching questions about what UK boards do in many of the areas the new regulations cover. We firmly believe that the focus by the Department for Business, Energy & Industrial Strategy (BEIS) and the Financial Reporting Council (FRC) on trust, governance and stakeholder accountability (including the much-discussed topic of directors' duties under section 172 of the Companies Act) makes it important for every management team and board to consider the impact on their company now, and to develop an implementation plan that takes into account both the new reporting requirements and the underlying procedures and judgements.

In April we hosted a roundtable that brought together quoted companies, investors and the FRC to explore the new regulations and the practicalities of implementing them. We had a really engaged and animated discussion covering the specifics of the non-financial reporting regulations as well as their broader significance.



This paper provides a summary of the key themes arising from the discussion as well as taking a look at what's in the new regulations and how they compare to the existing strategic report regulations. It also explores how prepared companies are based on their current non-financial reporting in the relevant areas.

1. The Companies, Partnerships and Groups (Accounts and Non-Financial Reporting) Regulations 2016, SI 2016 No 1245

2. The Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013, SI 2013 No 1970





# What's required, what's different?

## Scope

Figure 1 sets out the basic population to which the new regulations apply, i.e. Public Interest Entities.

This means that certain non-quoted companies will be reporting on these areas for the first time, as previously only quoted companies were subject to the full reporting on non-financial matters under the strategic report regulations. Only large companies or groups with over 500 employees are caught, however, and there are exemptions for certain subsidiary undertakings.

## A separate non-financial statement

The most obvious change for all companies is that the new regulations require a 'non-financial information statement' as part of the strategic report. Over recent years we have seen an improvement in the integration of information in annual reports, so there is a danger that the inclusion of such a separate non-financial information statement will be at the expense of a compelling, integrated narrative. As we discussed at the roundtable event, it's important therefore that when the FRC updates its Guidance on the strategic report later this year to take account of the new regulations it provides options that will allow companies to integrate non-financial information into their reporting where it's needed to tell their strategic story.

**Figure 1:** Extract from the non-financial reporting regulations: scope

(1) A strategic report of a company must include a non-financial information statement if the company was at any time within the financial year to which the report relates –

- a traded company,
- a banking company,
- an authorised insurance company, or
- a company carrying on insurance market activity.

[SI 2016 No 1245 S414CA(1)]

(3) Subsection (1) does not apply if –

- a. the company is subject to the small companies regime in relation to that financial year (see sections 382 to 384), or

- b. the company qualifies as medium-sized in relation to that financial year (see sections 465 to 467).

[SI 2016 No 1245 S414CA(3)]

(4) Subsection (1) does not apply if –

- a. where the company was not a parent company in that financial year, the company had no more than 500 employees in that financial year, or
- b. where the company was a parent company at any time within that financial year, the aggregate number of employees for a group headed by that company in that financial year was no more than 500.

[SI 2016 No 1245 S414CA(4)]



## Content requirements

Figures 2 and 3 highlight the difference in the contents of the new regulations compared to the existing strategic report requirements and, where applicable, the FRC Guidance on the strategic report. The analysis categorises them as a new requirement, a shift of a 'requirement' from guidance to regulation, or a variation on existing regulations.

The points in the first two of these categories include information on anti-corruption and anti-bribery matters, the impact of the company's activities and information on any due diligence processes in relation to the company's policies in the relevant areas.

**Figure 2:** Extract from the non-financial reporting regulations

Content elements	Additional requirement for quoted companies	Additional requirement for quoted companies – previously included in the FRC's strategic report guidance
	Variation in wording from the strategic report regulations	
	<b>414CB Contents of non-financial information statement</b>	
	(1) The non-financial information statement must contain information, to the extent necessary for an understanding of the company's development, performance and position and <b>the impact of its activity</b> , relating to, as a minimum:	
	(a) environmental matters (including the impact of the company's business on the environment),	
	(b) the company's employees,	
	(c) social matters,	
	(d) respect for human rights, and	
	(e) <b>anti-corruption and anti-bribery matters.</b>	
Business model	(2) The information must include:	
	(a) a brief description of the company's business model,	
Policies	(b) a description of the policies pursued by the company in relation to the matters mentioned in subsection (1)(a) to (e) <b>and any due diligence processes implemented by the company in pursuance of those policies,</b>	
	(c) <b>a description of the outcome of those policies,</b>	
Principal risks	(d) <b>a description of the principal risks relating to the matters mentioned in subsection (1)(a) to (e) arising in connection with the company's operations and, where relevant and proportionate:</b>	
	(i) <b>a description of its business relationships, products and services which are likely to cause adverse impacts in those areas of risk, and</b>	
	(ii) <b>a description of how it manages the principal risks, and</b>	
KPIs	(e) <b>a description of the non-financial key performance indicators relevant to the company's business.</b>	

The significance of these changes will vary depending on the specific circumstances. It's important to note that the information is required only 'to the extent necessary for an understanding of the company's development, performance and position' – in other words where it is material to the strategic report. The challenge is to think through whether all strategically material non-financial matters have previously been identified and disclosed appropriately, and whether additional information may now be required. See page 6 for further discussion of this area.

**Figure 3:** Extracts from the strategic report regulations/guidance

<p>(8) In the case of a quoted company the strategic report must, to the extent necessary for an understanding of the development, performance or position of the company's business, include:</p> <ul style="list-style-type: none"> <li>(a) the main trends and factors likely to affect the future development, performance and position of the company's business; and</li> <li>(b) information about: <ul style="list-style-type: none"> <li>(i) environmental matters (including the impact of the company's business on the environment);</li> <li>(ii) the company's employees; and</li> <li>(iii) social, community and human rights issues, including information about any policies of the company in relation to those matters and the effectiveness of those policies.</li> </ul> </li> </ul>	Content elements
<p>(8) In the case of a quoted company the strategic report must include:</p> <ul style="list-style-type: none"> <li>(b) a description of the company's business model.</li> </ul>	Business model
<p>7.34 Where information on a specific matter described in paragraph 7.29 is considered necessary for an understanding of the development, performance, position or future prospects of the entity's business, a description of some or all of the following items could be included in the strategic report when they are considered relevant:</p> <ul style="list-style-type: none"> <li>(a) the entity's policy in respect of the matter, together with a description of any measures taken to embed the commitment within the organisation;</li> <li>(b) any process of due diligence through which the entity: <ul style="list-style-type: none"> <li>(i) assesses the actual or potential impacts arising from its own activities and through its business relationships;</li> <li>(ii) integrates the findings from these assessments and takes action to prevent or mitigate adverse impacts;</li> <li>(iii) tracks the effectiveness of its efforts; and</li> <li>(iv) communicates its efforts externally, in particular to affected stakeholders; and</li> </ul> </li> <li>(c) the entity's participation in any processes intended to remediate any adverse effects that it has caused or to which it has contributed</li> </ul> <p style="text-align: right;"><i>FRC Guidance on the Strategic Report (June 2014)</i></p>	Policies
<p>(2) The strategic report must contain:</p> <ul style="list-style-type: none"> <li>(b) a description of the principal risks and uncertainties facing the company.</li> </ul>	Principal risks
<p>(4) The review must, to the extent necessary for an understanding of the development, performance or position of the company's business, include:</p> <ul style="list-style-type: none"> <li>(b) where appropriate, analysis using other key performance indicators, including information relating to environmental matters and employee matters.</li> </ul>	KPIs



### *The ‘materiality’ question*

The various areas in the new regulations only need to be reported ‘to the extent necessary for an understanding of the company’s development, performance and position and the impact of its activity’ and any risks need to be described ‘where relevant and proportionate’. Given that the non-financial information statement will be in the strategic report section of the annual report and the FRC has specifically confirmed on a number of occasions recently that the annual report is issued by companies for the benefit of their shareholders, it seems reasonable to assess the relevance of non-financial information from the point of view of shareholders. So the question for those preparing reports should be whether the information relates to activities that are going to affect the company’s ability to deliver on its strategy and generate sustainable returns for shareholders.

Companies and boards will need to be able to justify the judgements they make. Other stakeholder groups could look for reporting on the basis of what’s relevant for them as opposed to shareholders and there is a risk that, recognising this, companies will treat the new regulations as a ‘checklist’ of things to cover in the annual report. This is another area that it would be helpful for the FRC to clarify in the revised Guidance on the strategic report later this year.

The EU Directive that gave rise to the new regulations allows greater flexibility in how the non-financial information statement is reported than the UK requirements do – the non-financial statement can be outside the annual report, for instance. UK companies can of course continue to issue separate corporate social responsibility statements or sustainability reports that address stakeholder issues more broadly than the information that is required for the annual report.







## What we've seen – our survey

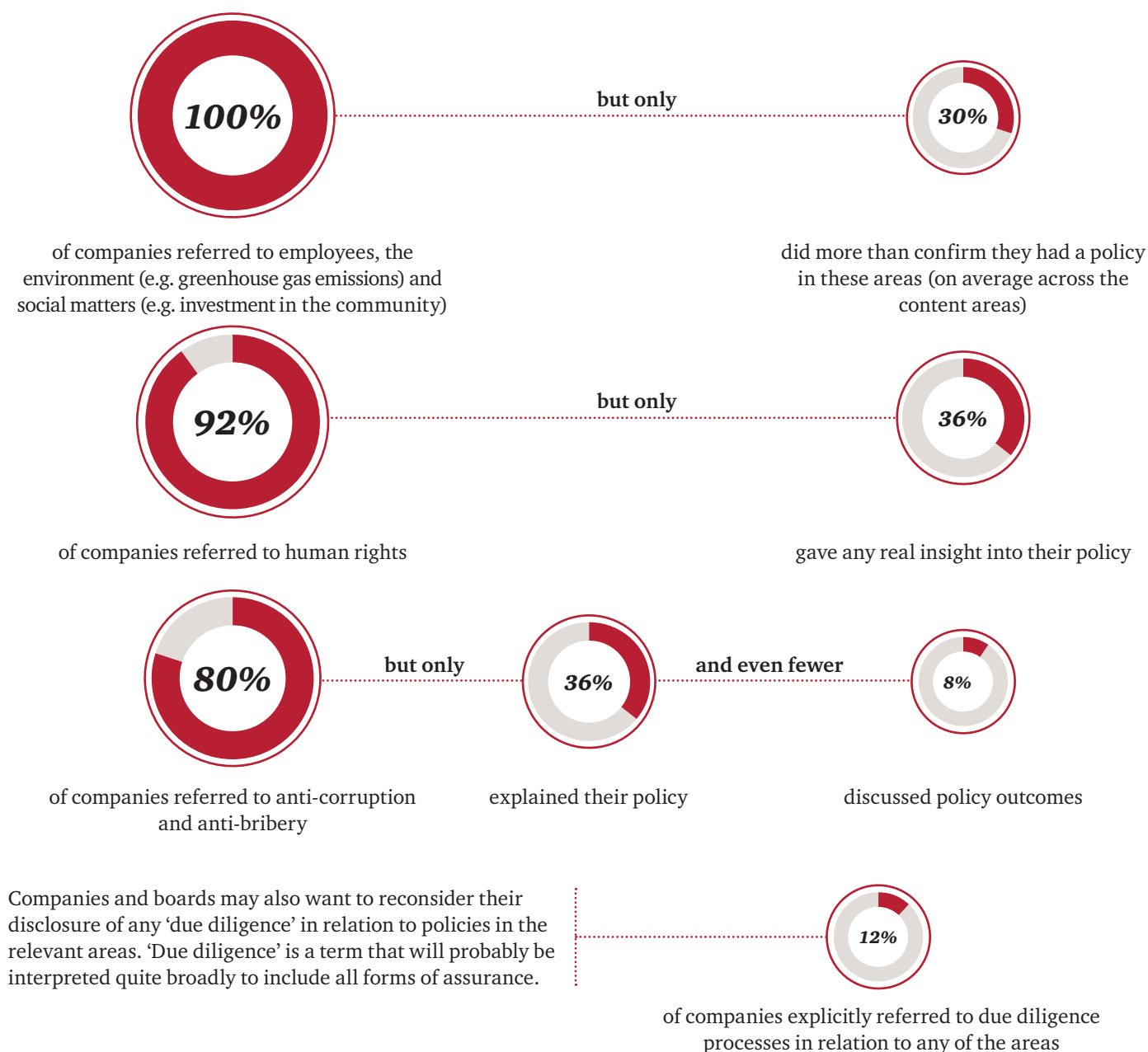
We recently performed a review of a sample of 25 FTSE 350 companies' non-financial reporting (for years ended up to December 2016) to explore how they stack up against the new regulations and identify where possible gaps may exist. It is clear that in practice companies will often need to make substantial changes to address the new regulations even in areas that are already part of the strategic report. We look at two instances of this in particular below: Reporting on policies and Reporting on impacts and outcomes.

### Reporting on policies

The strategic report regulations require 'information on' the relevant content areas, but the new regulations specifically ask for 'a description of policies'.

The information most companies currently choose to provide is limited and high-level, so this will have to change under the new regulations.

Figure 4: Findings from our review of current reporting



## Reporting on impacts and outcomes

The increased focus in recent times on accountability across many areas of society has resulted in a new emphasis on the impacts and outcomes of organisations. Having a policy and putting resource behind it is no longer enough – the evidence needs to be there that it is having the desired effect, or the policy is soon branded a failure.

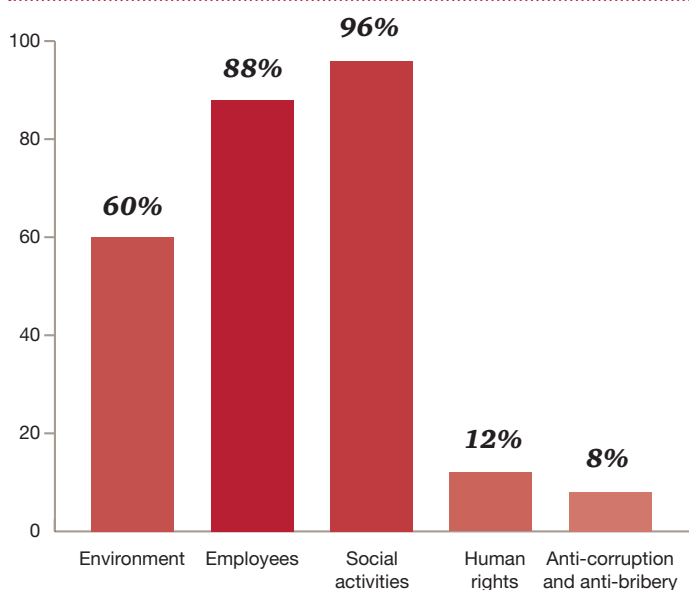
The new regulations bring reporting into line with this shift of focus. Companies not only need to provide information on their policies in relation to environmental matters, employees and the other areas listed in the regulations, they also need to describe the impacts and outcomes of those policies.

Many of these outcomes will be positive, demonstrating the contribution of businesses to society. But the regulations also require a description of ‘business relationships, products and services which are likely to cause adverse impacts’ in relation to risks associated with environmental matters, employees and so on.

It can be very difficult to measure the impact or outcome of a policy or activity – for instance how direct does it need to be and how can it be isolated from the effect of other influences? A few leading organisations are beginning to measure, and indeed report on, their impact but they are in the minority and practice will evolve over time.

Our survey showed (see Figure 5) that companies often refer to their activities in the relevant content areas. But a lot of the information remains qualitative, and focused on inputs rather than outputs. So in relation to employees, for instance, companies discuss investment such as the number of training days but don’t say anything about the impact these activities had on the skills, knowledge or experience of employees and how this has helped them to deliver on the company’s strategy. The approach that many currently take will not be enough under the new requirements.

**Figure 5:** % of companies at least referring to their impact on:





# What we've heard – our roundtable

The following messages emerged from the participants in our roundtable debate in April.

It was clear from the discussion that the impact of the new regulations will be more significant than first thought in many cases. It was also clear that investors take non-financial information seriously and build it into investment decisions: companies will not be wasting the time they spend on the new regulations.

## The extent of change

- The new requirements are very similar in form to a combination of the existing strategic report regulations and FRC Guidance, but the context for both the new and existing regulations has changed and the whole area of non-financial reporting will be more high profile
- The judgements companies make will need to stand up to scrutiny, including where they decide that an area doesn't need to be addressed

## Placement

- There is support from companies and investors for integrating the non-financial information into the rest of the strategic report, demonstrating compliance through cross-references if necessary

## Readiness

- Where the increased focus on non-financial reporting identifies any new areas to manage and/or report on this will need careful explanation, including any matters that have not yet been fully addressed. This could include the formalising of policies and any related 'due diligence' arrangements



## Materiality and the link to strategy

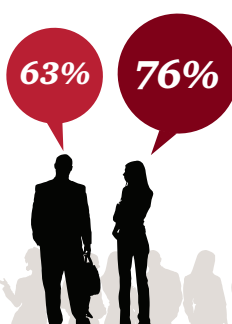
- Although it's clear that only strategically material non-financial information needs to be reported (information that is 'necessary for an understanding of the company's development, performance and position') some companies are likely to treat the regulations as a 'checklist' to avoid falling foul of particular stakeholder groups
- Materiality is not easy to define in this context, especially if it is extended beyond materiality to shareholders. This could also lead to companies including information because of its significance to particular stakeholder groups
- Investors are clear that the primary focus should be strategic materiality

## Measurement of impact and outcomes

- 'Impact' is often not easy to define so measuring impact (positive and negative) and the 'outcome of policies' could be challenging. Market practice needs to develop around this and users of annual reports should encourage innovation and experimentation
- Some investors will look for more quantitative indicators that are better integrated with delivering on strategy – qualitative, wholly positive statements will be treated as mere marketing/spin

## The effect on the principal risks

- The risks associated with non-financial matters only need to be disclosed if they are strategically material. Generally these should already be reflected in the principal risks



PwC's 2016 global survey of investor and CEO views identified that **63% of investors** and **76% of CEOs** think that business success in the 21st century will be defined by more than financial profit.

# Getting started

There may be further clarification of some aspects of the new requirements when the FRC issues its updated Guidance on the strategic report and no doubt market practice will emerge and continue to develop over time.

However, in order to get started, we've set out below a number of steps that companies should take now, if they haven't already done so:

1 **Familiarise** yourself with the new regulations

2 **Benchmark** your reporting against the new content requirements

3 Identify **possible gaps** in your disclosure

4 Identify whether **new information** needs to be collected

5 Assess the **quality** and **availability** of existing internal information to fill the gaps

6 Use a **senior sponsor** to engage the board around the regulation, gauge their appetite for going beyond compliance, and obtain agreement for what gaps to close and when

7 Obtain **buy-in** from your sponsor and board for the disclosures

8 Understand what **messages** the new information will convey to external observers and how it relates to existing messages

9 Determine how best to **present** and **integrate** the new information into the existing narrative





## Start a conversation

We hope this paper has been a useful contribution to the debate on implementing the new requirements. To find out more please contact:

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