DRAFT AMENDMENTS TO GUIDANCE ON THE STRATEGIC REPORT- NON FINANCIAL REPORTING

CONSULTATION

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ABOUT THE PRI

The United Nations-supported Principles for Responsible Investment (PRI) is the world’s leading initiative on responsible investment. The PRI has over 1800 signatories globally with approximately US $70 trillion in assets under management. Over 250 of these signatories are based in the UK1. This consultation response represents the views of the PRI executive.

The PRI welcomes the opportunity to respond to the Financial Reporting Council’s (FRC) consultation on changes to its Guidance on the Strategic Report.

ABOUT THE CONSULTATION

The FRC’s guidance on the strategic report is a statement of best practice for companies complying with the disclosure requirements enshrined in the Companies Act. First issued in 2014, the guidance is now being updated to reflect changes to the Companies Act following transposition of the Non-Financial Reporting Directive (Directive 2014/95/EU) and strengthen application of Section 172 of the Companies Act following the recent Corporate Governance Reform green paper.

The regulations to implement the Non-Financial Reporting Directive require qualifying companies to disclose “to the extent necessary for an understanding of the company’s development, performance, position and impact of its activity, information relating to environmental, employee, social, respect for human rights, anti-corruption and anti-bribery matters”. In our response to the Department for Business, Innovation and Skills (former), the PRI welcomed the implementation of the Directive, but encouraged the Government to recognise material non-financial disclosures as vital to a holistic, useful picture of a company, and treat them in line with traditional financial disclosures, including disclosure via the strategic report.

In our response to the Corporate Governance Reform green paper, the PRI noted extensive evidence that Section 172 has not been effective in promoting non-shareholder stakeholder interests in the boardroom. Amongst other issues, we recommended that the Government provide guidance to directors on how they can demonstrate that they have ‘had regard to’ broader societal and stakeholder interests in fulfilment of their duties under Section 172.

1See https://www.unpri.org/signatory-directory/
2The PRI also noted concerns with the term ‘non-financial’. The PRI prefers the term “Environmental, Social and Governance” (ESG) factors. The term ‘non-financial’ may be confusing to investors as the Law Commission’s guidance to pension funds on the fiduciary duties of investment intermediaries uses the term to mean matters which are not financially significant.
SUMMARY OF PRI’S POSITION

The Strategic Report is intended to provide shareholders with a “holistic and meaningful picture of an entity’s business model, strategy, development, performance, position and future prospects”.

The PRI welcomes the updated guidance, which will:

- create greater consistency between the FRC’s best practice guidance and evolving corporate disclosure requirements;
- further encourage companies to consider and assess environmental, social and governance (ESG) matters that may impact the business over the longer term, and therefore, increase the availability of relevant information to investors.

Such disclosures are necessary to allow investors to make informed investment decisions and fully assess the risks and opportunities associated with investments, which is fundamental to fulfilling their fiduciary duties. Below, we make several further recommendations for amendments to the guidance. Of particular importance, the amended guidelines reference climate risk, but do not yet reflect the final recommendations made by the Financial Stability Board’s Task Force on Climate-Related Financial Disclosures (TCFD), which were recently endorsed by the UK Government.

The PRI strongly recommends that the FRC:

- endorse the TCFD recommendations;
- integrate the TCFD recommendations into the guidance on the strategic report.

The PRI is contributing to the recently established UK Government Green Finance Taskforce, which is likely to consider disclosure of material climate risks further. We look forward to continuing to engage with the FRC and BEIS on these issues as the Taskforce recommendations develop.

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3 See Fiduciary Duty in the 21st Century UK Roadmap (PRI, 2016)
CONSULTATION RESPONSES

The PRI is providing a response to questions 1-4 and 6-8 of the consultation.

**Question 1**

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

The Strategic Report is intended to provide shareholders with a “holistic and meaningful picture of an entities business model, strategy, development, performance, position and future prospects”. The PRI supports the approach for updating the guidance, which recognises that ESG factors are integral to fulfilling this purpose, and that key ESG risks and opportunities should therefore be included in the strategic report.

Companies should avoid disclosure of boiler-plate or generic ESG reports. Companies should be guided to prioritise their ESG risk / opportunity factors to enable investors to assess the board’s view of the key risks and vulnerabilities specific to its business and sector. A deliberative, specific and responsive approach is vital as it reflects the changing nature of the business environment in which UK companies operate.

The PRI’s Fiduciary Duty Roadmap⁵, produced in consultation with stakeholders from across the UK capital market, finds that investors require timely, decision-useful information on a firm’s operating performance and financial prospects, of which ESG factors are a core component, to make informed voting and investment decisions and to direct meaningful engagement activities. Such disclosures are necessary to allow investors to make informed investment decisions and fully assess the risks and opportunities associated with investments, which is fundamental to fulfilling their fiduciary duties.

**Question 2**

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

The PRI welcomes the amendments to section 4 (The strategic report: purpose), which put greater emphasis on long-term value creation and its dependence on non-financial factors, stakeholder relationships and the impact of a company’s activities on society as a whole. These amendments are consistent with the PRI’s understanding of high quality corporate reporting, and echo recommendations made in the Fiduciary Duty Roadmap.

The updated guidance also recommends that the strategic report provide “sufficient information” to help members of the company understand how the directors have fulfilled their duties under

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⁵ See Fiduciary Duty in the 21st Century UK Roadmap (PRI, 2016)
section 172, but provides limited guidance on what “sufficient information” is. While we support the intent, greater specificity is needed.

**Recommendation:** The FRC provide specific guidance on how company directors can demonstrate that they have ‘had regard to’ broader societal and stakeholder interests in fulfilment of their duties under Section 172.

**Question 3**

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

Paragraph 7.25 of section 7 now states that ‘where the entity is facing long term system risks which may have a material effect on the entity’s ability to generate and preserve value in the long term, for instance risks arising from climate change, changing technology, the strategic report should explain how the directors expect the entity’s strategy and business model to change’.

Climate change is increasingly material to the financial sector. Mark Carney, the Governor of the Bank of England\(^6\) has identified three types of climate related risks:

- **Physical:** risks that could arise from extreme weather events such as flooding and storms which could damage property, national infrastructure and disrupt trade.
- **Transition:** risk that could arise from the process of adjusting to a lower-carbon economy, such as changes in policy, technology, or investor sentiment.
- **Liability:** risk that could arise from parties who have suffered loss or damage. The interconnected nature of the global financial system, could expose Canadian financial institutions to claims that occur in third countries.

Despite this, corporate reporting in the UK is falling short. Research from Carbon Clear indicates that, amongst FTSE 100 companies, just 55 assess climate-related risks to their business in the annual report\(^7\).

Financial regulators have a clear interest in ensuring the financial system is resilient to any economic transition. An efficient market reaction to climate risks would be founded on the transparency of information. It will help smooth price adjustments as information changes, rather than concentrating them in a single climate “Minsky moment”. The Financial Stability Board Task Force on Climate-Related Financial Disclosures (TCFD) in collaboration with investors, lenders, insurers and other stakeholders from across the globe has developed voluntary recommendations for standardising climate change disclosure thereby increasing the availability and use of comparable climate-related, financial and risk management information.

In a recent study of the UK legislative framework, the PRI noted that the TCFD recommendations supplement the existing disclosure regulations in relation to financially material risk. The proposed

\(^6\) Source the Bank of England webpage on “Climate change, green finance and financial stability” http://www.bankofengland.co.uk/pages/climatechange.aspx

\(^7\) https://carbon-clear.com/resource/case-studies/ftse-100-carbon-reporting/
guidelines on the strategic report mention climate risk in several places, but do not mention TCFD. This update provides an opportunity to encourage uptake of the TCFD recommendations as a best-practice framework for disclosing material climate risk.

**Recommendation: The FRC should:**
- Endorse the TCFD recommendations.
- Integrate the TCFD recommendations into the guidance on the strategic report.

**Question 4**

Do you agree with the draft amendments to Section 5?

The amendments seek to clarify the use of the concept ‘material’ in the guidance. The PRI agrees with the view that the strategic report should focus on those matters that are material to an understanding of the development, performance, position, future prospects, and (now amended to include) non-financial information. It is important that companies provide the necessary context and report ESG factors with information connected with the core operations of the business.

In addition, the PRI welcomes the statement that the information needs of long-term investors should be considered (5.3). The FRC should ensure companies report on risks and opportunities that are or may be financially material over an investment timeframe consistent the end investor, which may be a pension fund with investment liabilities of 20, 30 or more years.

**Question 5**

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

No additional comments.

**Question 6**

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

The PRI agrees with the articulation of sources of value (7.17) to the effect that:

“…a critical part of understanding an entity’s business model is understanding its sources of value, being the key resources and relationships that support the generation and preservation of value. In identifying its key sources of value, an entity should consider both its tangible and intangible assets and consider those resources and relationships that have not been reflected in the financial statements because they do not meet the accounting definitions of assets or the
criteria for recognition as assets. This information may provide insight into how the board manages, sustains and develops these unrecognised assets.”

However, the ‘sources of value’ section could be strengthened in two ways:

- Consistent with other elements in section 7 (see below) and in section 4 (see our response to question 2), we recommend greater emphasis on the relationship between long-term value creation and its dependence on non-financial factors, stakeholder relationships and the impact of a company’s activities on society as a whole.
- We recommend rephrasing the example disclosure under paragraph 7.17. While we agree that an entity may generate value from corporate reputation, the current phrasing underplays the significance of the ‘other’ sources of value listed, including natural resources and employee relations.

Within section 7 more broadly, we welcome the increased emphasis on the following:

- Non-financial factors should be considered integral to the strategic report.
- The company should clearly disclose linkages between financial and non-financial factors and values, behaviours and cultures that the company pursues.
- The company should provide forward-looking information on how the entity’s strategy and business model may change in response to long-term systemic risks, such as climate change or changing technology (however, we believe the disclosures in relation to climate could be improved by reference to the TCFD recommendations – see question 3 for further elaboration on this).
- The company should disclose non-financial KPIs necessary to fulfil the purpose of the strategic report, including how directors have fulfilled their duties under section 172.

**Question 7**

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

Yes (see response to questions 2 and 6 for further context).

**Question 8**

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

Yes, noting the recommendations made in the above questions.

**Question 9**

**Are there any other specific areas of the Guidance that would benefit from improvement?**
No additional comments.