Climate Disclosure Standards Board

UK Financial Reporting Council (FRC) Consultation on Draft Amendments to Guidance on the Strategic Report: Non-Financial Reporting

CDSB Consultation Response – 24 October 2017

The Climate Disclosure Standards Board (CDSB) welcomes the opportunity to offer our written response to the Draft amendments to the Guidance on the Strategic Report: Non-financial reporting (the **Exposure Draft**) and accompanying draft Guidance on the Strategic Report (the **FRC Staff Draft Guidance**). (See: https://frc.org.uk/news/august-2017/frc-consults-on-non-financial-reporting-guidance)

CDSB is an international consortium of nine business and environmental NGOs. We are committed to advancing and aligning the global mainstream corporate reporting model to equate natural capital with financial capital. We do this by offering companies a framework for reporting environmental and climate information (the **CDSB Framework**) with the same rigour as financial information. In turn, this helps companies to provide investors with decision-useful environmental and climate information via the mainstream corporate report, enhancing the efficient allocation of capital. Regulators also benefit from compliance-ready materials. Recognising that information about natural capital and financial capital is equally essential for an understanding of corporate performance, our work builds the trust and transparency needed to foster resilient capital markets. Collectively, we aim to contribute to more sustainable economic, social and environmental systems.

This consultation on amended guidance for the strategic report is timely as entities consider how they can satisfy their obligations under the EU Non-Financial Reporting Directive (and related non-financial reporting regulations) and address these in their strategic report in the next reporting cycle. At the same time, this affords the FRC an opportunity to support companies who are looking for guidance in relation to other key developments in the non-financial reporting sphere, such as how best to implement recommendations from the Task Force on Climate-related Financial Disclosures (the **TCFD**) and integrate these into their annual reports, particularly within the strategic report.

This response has been prepared with the advice of CDSB's Technical Working Group. Please find our comments below and do not hesitate to contact us if we can be of further assistance.

Best regards,

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General Comments on the Exposure Draft and Draft Staff Guidance

We have the following general comments on the amended draft guidance on the strategic report[1]:

Further clarity is needed regarding the intended audience for the information provided in the strategic report. There appears to be somewhat mixed messaging as to whether and to what extent information for other stakeholders (beyond members of the company, i.e. shareholders) should be provided for in the annual report and strategic report contained therein.

Paragraph 3.13 states that: “information should be placed in the annual report when it is material to shareholders” and that information “that is provided to meet the needs of individual stakeholders should be placed elsewhere (e.g. online or in another report), where law or regulation permits”. This implies that the strategic report and the annual report more broadly should only contain information that is material to shareholders. However, in paragraph (xii) the previous reference in the current form of the FRC’s strategic report guidance to *only* including information material to shareholders has been amended to state that “information that is material should be included to the strategic report”. It does not state to whom the materiality assessment applies and therefore one could infer the materiality could relate to other stakeholders. The same paragraph refers to the strategic report as not only meeting shareholders’ needs but providing “information which is useful to another entity’s stakeholders taken as a whole and will meet many of their information needs”. In paragraph (xi), the FRC asserts that information in the annual report will be useful to other stakeholders whereas paragraph (ix) advocates for inclusion of information to other stakeholders to be “provided outside the annual report….”. As such, we suggest replacing “will” with “may” [*be useful for other stakeholders]*.

However, when implementing the EU Non-Financial Reporting Directive (2014/95/EU) (the **NFRD**), a conflict does arise because the directive considers users of non-financial information to include a broad range of stakeholders. FRC may need to address the issue of how to reconcile the two perspectives more directly, especially as the guidance is intended to assist companies in implementing the requirements of the Directive.

We suggest deeper integration of the TCFD recommendations is needed. Given that paragraph (vi) in the Overview states that “The Guidance on the Strategic Report serves as a best practice statement…”, it should incorporate more reference to leading practices in corporate reporting outlined in the TCFD recommendations. Not only would this help to promote high quality corporate governance and reporting to foster investment, but it would also future-proof the revised Guidance from having to update it in the near future, as reporting in line with the TCFD becomes more common practice. Implementing the TCFD recommendations would help the FRC to satisfy its mission to promote transparency and integrity in business and would support the needs of its stakeholders (i.e. to serve investors and others who rely on company reports, audit and high-quality risk management).

There are some references to 2013 law as new law and BIS which could be updated in the overview section. For example, paragraph (iii) on page 3, refers to The Department for Business, Innovation and Skills (BIS). You may wish to change this to “In [2013], the then Department for Business, Innovation and Skills (BIS), now part of The Department for Business, Energy and Industrial Strategy (BEIS)…”. The reference to “new” legal requirements in the same first sentence should be changed to “the 2013 legal requirements”.

We note that the FRC has produced a fact sheet on non-financial reporting. We trust that this will be updated in light of any changes made to the Strategic Report Guidance arising from this consultation. Similarly, will a second version of the revised Strategic Report Guidance be issued to take into account the Government’s

[1] Note that all references to paragraphs here are to the FRC Draft Staff Guidance unless expressly stated otherwise.

expected response to the BEIS Green Paper on Corporate Governance Reform, following the consultation on this paper which closed in February 2017?

The FRC needs to assess the effectiveness of its amended strategic report guidance. This is crucial for providing the market with feedback on their climate change and wider non-financial reporting**.** While we recognise that the FRC's remit for supervising certain "non-financial" information is under discussion, it can use other methods to educate and encourage innovation in reporting. This may take the form of staff notes, comment letters and examples of best practice, among others. An avenue to provide such feedback could be the annually issued "Summary of key developments letter" from the FRC's Chief Executive, which has included commentary on climate risk reporting in the past[2].

We also wish to draw your attention to the approach in the Netherlands taken by De Nederlandsche Bank (DNB), the Dutch Central Bank, financial sector supervisor and resolution authority:
"This impact can be felt increasingly strongly in a variety of areas, which is why DNB intends to embed climate-related risks more firmly in its supervision with the ultimate aim of ensuring sustainable financial stability."[3]

We welcome the clarification between section 172 'Duty to promote the success of the company' and the strategic report, but this needs to be clarified even further. Guidance from the FRC is clear that the Directors of the Board are expected to be responsible for the company's financial and non-financial performance, including governance, policy and due diligence. However, we do not think this is clear enough in practice for Directors who have not considered these issues before. Non-financial Reporting is not yet considered to be an issue that will become an ongoing concern for businesses. As such, its governance is still common to be delegated to communications or legal teams as a compliance issue. The FRC should make further clarify that there are new expectations of Directors, which will require Board level discussion and action. As such, we suggest using clearer language in expectations, outcomes and actions to attract the attention of Directors and Board Chairs.

We suggest adding links to other relevant reporting requirements to help businesses consolidate their obligations. For example, we suggest providing a link to the DEFRA Adaptation Reporting Power (Climate Change Act 2008) which gives the Secretary of State authority to periodically require certain UK organisations prepare and publish a climate change resilience plan. These organisations are mainly infrastructure owners, providers or operators. This is now entering its third round of reporting and there is a clear link between the outcome of these organisation's resilience plans and that of the Non-financial Reporting requirements to report on environmental matters, specifically risks and outcomes regarding climate change.

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[2] https://www.frc.org.uk/getattachment/8b201a21-987e-47cb-aea6-62b2febcc782/Year-end-advice-letter-to-companies-letter.pdf

[3] https://www.dnb.nl/en/news/news-and-archive/dnbulletin-2017/dnb363837.jsp#

Invitation to Comment – Responses to the Specific Consultation Questions

Approach to update

Question 1 – Do you agree with the approach to updating the Guidance for the changes arising from the implementation of the non-financial reporting Directive?

Yes, FRC's Guidance on the Strategic Report should consider the impact of key legal and regulatory developments in the non-financial reporting sphere, such as the NFRD. The FRC Staff Draft Guidance should be comprehensive and cover the full suite of such developments, including any obligations placed on entities in respect of the production and content of their strategic report.

The approach taken to updating the FRC Staff Draft Guidance to address changes made by the NFRD has been to:
(a) integrate the requirements throughout the main body of the guidance, including adding a new section on non-financial reporting in section 7; and
(b) insert a new Appendix IV on "the Companies Act 2006 Strategic Report Non-Financial Reporting Disclosure Requirements".

This appears to be a sensible approach. We believe it would be helpful to separately refer to Appendices III and IV – directing entities within scope of the NFRD to Appendix IV and all other entities to Appendix III. A short introduction to Appendix IV explaining how the *Companies, Partnerships and Groups (Accounts and Non-Financial Reporting) Regulations* 2016 (SI 2016/1245) (the **NFR Regulations**) amend the 2006 Companies Act and implement the NFRD in the UK would also be beneficial. Appendix IV currently refers to companies within the scope of the "non-financial reporting Regulations". The reference to the "Regulations" could be made more specific. You may wish to note in Appendix IV when applicable companies and qualifying partnerships are obliged to report such information, i.e. in respect of financial year beginning from 1 January 2017.

In future, revised Guidance on the Strategic Report could be refined to include examples of good practices of non-financial reporting once there is a developed body of practice following applicable companies and qualifying partnerships having had a full year of financial reporting upon which to base and satisfy their non-financial disclosure obligations under the NFRD/NFR Regulations. We recognise that it will take time to build up and analyse these reports and experiences. In the interim, we suggest that the FRC consider signposting intended users of the FRC Staff Draft Guidance to CDSB and CDP's 2016 publication: *EU environmental reporting handbook What could environmental reporting in line with the Non-Financial Reporting Directive look like?* (See: http://cdsb.net/NFRhandbook). These examples provide helpful guidance to reporting companies that can help them improve the content and quality of their Strategic Reports.

On 26 June 2017, the European Commission issued a Communication from the Commission: Guidelines on non-financial reporting (methodology for reporting non-financial information) C(2017) 4234 final. These non-binding guidelines are referred to in paragraph (xv) on page 5. However, it is unclear to what extent these guidelines, and their underlying key principles, have been incorporated fully into the FRC Draft Staff Guidance. This could be made more explicit in the FRC Staff Draft Guidance.

We note that although there is a distinction between the applicability of the NFRD/NFR Regulations and the Companies Act 2006 (as amended) to companies, the FRC Staff Draft Guidance does not reflect the difference in scope of applicability. While paragraph 2.2. states that "…the extent of disclosure that is required for a company will vary according to the type of company", it goes on to state that "the guidance does not differentiate on this basis". It adds that it is "best practice to disclose information that is necessary for an understanding of the development, performance, position or future prospects of the entity or the impact of its

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activity in the strategic report, irrespective of the existence or otherwise of an explicit statutory requirement". We are not sure whether it is appropriate for guidance to suggest that all companies should disclose information when the legislative provisions only impose particular requirements on certain companies. An explanation of the scope of these two sets of requirements can be found on the CDSB website (see: http://cdsb.net/UKGHG).

The purpose of the strategic report and section 172

Question 2 – Do you support the enhancements made to Sections 4 and 7 to strengthen this link?

Yes, in principle, we support the enhancements made to Section 4 and 7 of the Guidance to strengthen the link between s.172 of the Companies Act 2006 (i.e. directors' duty to promote the success of the company) and the purpose of the strategic report (i.e. to provide shareholders with information to enable them to assess how directors have performed their duties). Company success is now qualified as "for the benefit of the members as a whole".

We note, in particular, the new emphasis in Section 4 on the purpose of the strategic report as also providing information on the impact of the entity's activities (See paragraphs 4.3 and 4.4). This is in addition to the information on the strategy, development, performance and position. However, it is unclear how this is then reflected in the content elements of the strategic report in Section 7.

In paragraph 4.2, there is a new focus on provision of information in the strategic report about building relationships with stakeholders - as these affect the company's ability to generate and preserve value and provide insight into its purpose. Moreover, previous guidance on the strategic report's purpose stated that the information in it should ***complement*** information in the financial statements, whereas paragraph 4.6 now states that there should be ***consistency*** between the strategic report and the information presented in the financial statement. Consistency appears to be a higher bar to meet than having complementary information, which we see as a positive change in the guidance.

We believe that the content elements in section 7 of the amended guidance should incorporate the core elements and supporting recommended disclosures of the TCFD recommendations on strategy, governance, risk management, and metrics and targets.

Question 3 – Do you have any suggestions for further improvements in this area?

See response to question 2 above.

Materiality

Question 4 – Do you agree with the draft amendments to Section 5?

No, Section 5 could benefit from further revision. There is new wording throughout the draft guidance (see in particular paragraph (xiv) on page 5, paragraph 2.2 on page 8, and paragraph 4.3 on page 20) about the need for a company to consider "the impact of their activity." Does this create confusion and conflict with the need for materiality to be entity-specific? Materiality is entity-specific based on the nature or magnitude (or both) of the actual or potential effect of the matter to which the information relates. It requires a director to apply judgement based on their assessment of the relative importance of the matter to the <u>entity's development</u>, performance, position or future prospects. This may not square the entity-specific nature of disclosure – i.e. looking inward to matters and issues that affect the company with the outward focus on <u>the impact of its activity</u>. More guidance and examples by the FRC could prove beneficial. Similarly, how does this relate to the TCFD's approach to scenario analysis? Is that a technique that the FRC could advocate for use in

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predicting impacts? There is also a need to consider a longer-term timeframe on a consistent basis, which could be by linking it to the viability statement.

Paragraph 5.6 on page 18 adds the following new text: "…in the context of qualitative information in general and non-financial information in particular a numerical materiality figure (the auditing materiality figure) is of less importance". We note that qualitative factors may often have a greater influence on the determination of materiality, particularly in relation to non-financial information, and a separate assessment may be required. Could the FRC expand on this point? What is meant by a "separate assessment"? Does it mean companies use a quantitative test for financial statements and another assessment for non-financial information? Further guidance in this area is needed.

Finally, paragraph 5.2 on page 18 of the Exposure Draft notes that: (a) the shareholder base may comprise groups with different needs and interests; and that (b) the needs of all significant shareholder groups should be taken into account when determining whether a matter is material including those who take long-term view on investment. Furthermore, when determining whether a matter is material, the company should consider whether it would affect the ability of the company to generate or preserve value in the long term. There is insufficient information on how to make decisions about materiality in the "long-term" and it is unclear what creation or preservation of value means in the context of the strategic report. These terms need to be defined and further guidance provided.

Linkage

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?

A new paragraph 6.14 is inserted into the draft guidance which states that "Entities should communicate relevant information that enables shareholders to assess the factors that may have an impact on the long-term success of the business. This may involve looking beyond the strategic planning horizon of an entity". This affords an opportunity for the FRC to links its guidance to that contained in the final report of the TCFD, particularly in the context of forward-looking information.

We note that paragraph 6.25 has been amended and now reads: "The structure and content of the strategic report should be reviewed annually to ensure that is continues to meet its purpose and contains information that is relevant". We considered whether relevance is the right test for information in the strategic report or should it be materiality. On the premise that the strategic report should **only** contain material information, relevance seems adequate.

Core elements

Question 6 – Do you agree with how the sources of value have been articulated in the draft amendments to the section on strategy and business model in Section 7?

Question 7 – Do you consider that disclosures on how value is generated would be helpful?

Yes. This appears consistent with the Companies, Partnerships and Groups (Accounts and Non-Financial Reporting) Regulations 2016 requirement to provide a brief description of the undertaking's business model (414CB(2)(a)). We recommend the reference and use of the International <IR> Framework's guidance on value creation and business model to help consider and include different inputs and outputs within the strategic report.

We also feel that this is an area where the FRC could provide further guidance to companies. Standardised metrics would also be helpful to facilitate comparability.

Question 8 – Do you consider that the draft amendments relating to reporting of non-financial information give sufficient yet proportionate prominence to the broader matters that may impact performance over the longer term?

The FRC have inserted new guidance on non-financial reporting in paragraphs 7.30 to 7.43. Under 7.32 it states that to the extent necessary for an understanding of the development, performance or position and impact of its activity, at minimum the strategic report should include non-financial information relating to: environmental matters (including the impact of the entity's business on the environment), on employees, social and community, human rights, anti-corruption and bribery matters. The next paragraph advises the board to consider the impact of the entity's activity disclosing material information to the entity's long-term success. Moreover, in paragraph 7.36 the strategic report must also include a description of related non-financial policies, and where they do not exist a 'clear and reasoned explanation' for not doing so.

While there are examples provided of reporting on policies for human rights, anti-corruption and bribery, it might be helpful to include examples of reporting on policies and outcomes across a broader range of non-financial matters as well as to link to external resources available to aid in making such disclosures.

In conclusion, we believe that climate risk should be given greater prominence in the guidance, as a broad matter that may impact longer-term performance of an entity.

Other

Question 9 – Are there any other specific areas of the Guidance that would be benefit from improvement?

No, please see comments above.

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