ShareAction
the movement for Responsible Investment

16 Crucifix Lane
London, UK
SE1 3JW
+44 (0) 20 7403 7800

Deepa Raval
Financial Reporting Council
8th Floor
125 London Wall
London
EC2Y 5AS

Sent via email to narrative@frc.org.uk

24 October 2017

Dear Ms Raval,

Draft amendments to Guidance on the Strategic Report

I am writing to respond to the FRC's consultation on draft amendments to the guidance on the strategic report on behalf of ShareAction, a registered charity established to promote transparency and responsible investment ("RI") practices by pension funds and other institutional investors. We are a member organisation and count amongst our members well-known NGOs and charitable foundations, as well as over 26,000 individual supporters.

We work with institutional investors to promote stewardship and engagement on the kinds of issues covered by the FRC's draft strategic report, and we also conduct annual industry-wide surveys to rank them on these activities. We have extensive experience of research and policy development on barriers to long-termism, and fed into the 2012 Kay Review, the related BIS Select Committee, the Law Commission's review of trustees' fiduciary duty and the recent BEIS Select Committee on corporate governance. Our work with investors has shown us their need for clear, comparable information in companies' strategic reports.

I have responded to Questions 1, 2, 3, 4, 6 and 8 of the consultation below.

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?

As noted in the consultation document, there is a large amount of overlap between the new non-financial reporting requirements and the pre-existing strategic reporting requirements. Therefore, we agree that it makes sense to incorporate the amendments into the guidance so that the strategic report remains a single cohesive document.

Question 2: Do you support the enhancements that have been made to Sections 4 and 7 of the Guidance to strengthen this link?

We are happy with the general approach taken by the FRC to strengthen the link between the purpose of the strategic report and the broader, more long-term factors set out in section 172 of the Companies Act. We agree that the intended audience of the annual report should be the shareholders of the company. The Companies Act was designed to introduce an era of enlightened shareholder value, in which companies and their directors would focus on long-term success and consider their impacts on staff, suppliers, communities and the environment. More still needs to be done to ensure that shareholders are acting as the long-term, active owners envisaged by the Act and that they shape directors' incentives accordingly. For example, the FRC's 2016 report on corporate culture[1] found that "excessive focus by shareholders on short-term performance – or the perception that this is the case – can be a driver of poor behaviour". We think it would be helpful for section 4 to include a statement emphasising that the strategic report is a tool for shareholders to use in selecting, retaining and stewarding their investments in companies over the long term, not information for the sake of information.

Recommendation

Section 4 should include a statement emphasising that the strategic report is a tool for shareholders to use in selecting, retaining and stewarding their investments in companies, not information for the sake of information.

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

In reference to new paragraph 7.43, we believe it would be helpful for the FRC to ask companies to report against particular criteria (both general and sector-specific). We understand the importance of keeping this guidance succinct and relevant to all reporting entities. We also appreciate that the FRC wants to adopt a principles-based approach to allow companies to tell their own story. However, this often translates in practice to companies reporting 'good news stories' (i.e. successes or problems which have been solved) rather than the real difficulties and issues that investors focused on the long term should know about. In the Eurosif and ACCA 2013 survey *What do investors want from non-financial reporting?*, 84% of investors surveyed disagreed or strongly disagreed or strongly disagreed that companies make it clear how they identify material non-financial issues.[2] Moreover, the varied approaches that companies take to reporting makes it very difficult for investors to compare reports. 92% of investors surveyed by ACCA/Eurosif disagreed or strongly disagreed that current reporting is sufficiently comparable and 84% agreed or strongly agreed that established standardised reporting frameworks should be used by companies. More needs to be done to ensure all key data is included within the strategic report and that this is done in a standardised format.

For example, the 2015 annual report from Sport Direct[3] includes quite detailed workforce data, such as workforce turnover, gender diversity on the board, and the number of hours dedicated to employee training. The only mention of casual workers is the following: "Much of the comment regarding the Group's use of zero hour contracts has been unfounded and inaccurate. We comply fully with all legal requirements which relate to casual workers, including sick pay, holiday pay, and freedom to gain other employment. Casual workers also participate in general incentive schemes." The group's pre-tax profits then tumbled by 47% to £277.7m in the year to 26 April 2016, according to accounts filed with Companies House.[4] This was largely due to a December 2015 Guardian investigation about working conditions at

[1] i Financial Reporting Council (July 2016). Corporate Culture and the Role of Boards, p31. Available online at: https://www.frc.org.uk/getattachment/3851b9c5-92d3-4695-aeb2-87c9052dc8c1/Corporate-Culture-and-the-Role-of-Boards-Report-of-Observations.pdf [accessed 23 October 2017].

[2] ACCA and Eurosif (2013). *What do investors want from non-financial reporting?* Available from: http://www.accaglobal.com/content/dam/acca/global/PDF-technical/sustainability-reporting/tech-tp-wdir.pdf [accessed 23 October 2017].

[3] Sports Direct (2015). *Sports Direct 2015 Annual Report*. Available from: http://www.sportsdirectplc.com/~/media/Files/S/Sports-Direct/annual-report/Annual%20Report%202015%20-%20FINAL.pdf [accessed 23 October 2017].

[4] Man, P-G (27 September 2017). Drapers, 'Mike Ashley's firm hit by Sports Direct troubles'. Available from: https://www.drapersonline.com/news/mike-ashleys-firm-hit-by-sports-direct-troubles/7026318.article [accessed 23 October 2017].

their warehouse in Derbyshire, where apparently more than 80% of staff were on zero hours contracts. This gave rise to widespread criticism, a Parliamentary inquiry and concerns about the governance of the company.

Although Sports Direct is an extreme example, many other companies also fail to report on core workforce data. This is demonstrated in the analysis of Bloomberg data quoted in the PLSA's 2015 report, *Where is the workforce in corporate reporting?,*[5] which states, in relation to the FTSE 100:

- 94% of companies report on total headcount.
- 11% of companies report on workforce composition (e.g. number of part-time and/or temporary staff).
- 47% of companies report on levels of staff turnover or attrition.
- 24% of companies report on total investment in training and development.

As set out in the 'Recommendations' sub-section below, the FRC should ask all companies to report against key areas of non-financial information that are applicable across all sectors. The European Federation of Financial Analysts Societies (EFFAS) has identified nine topics as applying to all sectors and industries, set out below. The FRC should also ask companies in specific sectors to report against external reporting frameworks for those sectors.

ShareAction and Oxfam have developed a workforce data disclosure project (the Workforce Disclosure Initiative[6]), which aims to fill in the gap of workforce data currently not being supplied to investors by companies. We would be pleased to meet with the FRC to discuss how our methodology could be of use in this area. I have included more information about the DFID-funded Workforce Disclosure Initiative in the appendix to this response.

However, we are not best placed to suggest the most appropriate disclosure frameworks for every sector and/or issue. Some useful suggestions are included within the European Commission's non-financial reporting guidance.[7] That said, we think this information could best be obtained from representatives from specific business sectors and the civil society organisations that focus on these sectors.

Recommendations

- The FRC should ask all companies to report against the key areas of non-financial information which are applicable across all sectors. The European Federation of Financial Analysts Societies (EFFAS) has identified nine ESG topics as applicable to all sectors and industries:
    - Energy efficiency;
    - Greenhouse gas (GHG) emissions;
    - Staff turnover;
    - Training & qualification;
    - Maturity of workforce;
    - Absenteeism rate;
    - Litigation risks;

[5]NAPF (June 2015). *Where is the workforce in corporate reporting?* Available from: http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:52017XC0705(01)&from=EN [accessed 23 October 2017].
[6] ShareAction. Workforce Disclosure Initiative. Available from: http://shareaction.org/wdi/ [accessed 23 October 2017].
[7] Financial Stability, Financial Services and Capital Markets Union (June 2017). *Commission guidelines on non-financial reporting*. Available from https://ec.europa.eu/info/publications/170626-non-financial-reporting-guidelines_en [accessed 23 October 2017].

- [Anti-c]orruption [and anti-bribery];
- Revenues from new products.[8]

- In addition to this, the FRC should also ask companies in specific sectors to report against external reporting frameworks. We suggest that these should cover, but are not limited to, the following:
  - Other environmental matters (for example, natural capital management);
  - Further relevant data on the company's employees;
  - Other social matters (for example, supply chain issues, consumer protection and animal welfare); and
  - Respect for human rights (for example, indigenous rights and conflict minerals).

- The FRC should ask representatives from specific business sectors and the civil society organisations that focus on these sectors to recommend disclosure frameworks for each of the above issues/sectors.

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

We are pleased to see the confirmation that '[w]hen considering whether information is material, an entity should consider whether the fact or circumstance would affect the ability of the entity to generate or preserve value in the long term' in paragraph 5.4. The difficulty that this presents is that 'long term' will have different meanings for different individuals end entities. Some non-financial risks may not be relevant to a particular entity over the next five years, but may be very relevant to the performance of the entity over the next 20 years. Allowing companies to define the meaning of 'long term' may mean that some long-term investors, such as pension funds, do not have the information or confidence to reap the benefits of a 'buy-and-hold' approach.[9] It may be helpful to include a statement along the following lines at the end of paragraph 5.4:

"Some shareholders may have investment horizons of up to 40 years. Directors should consider principal risks and uncertainties that may be material over a number of different time horizons and report on these variables in the strategic report. This could be divided into 5-year time periods, i.e. 'Over 5 years', 'Over 10 years', 'Over 15 years', 'Over 20 years'."

This wording could also be included at the end of paragraph 6.14.

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?

Not answered.

---

[8] The European Federation of Financial Analysts Societies (January 2014). *KPIs for ESG*. Available from: http://ec.europa.eu/DocsRoom/documents/1547/attachments/1/translations/en/renditions/pdf [accessed 23 October 2017].
[9] A timeframe of five years is usually suggested as the minimum for equity market investment, on the basis this allows investors to experience the ups and downs of a normal market cycle. Analysis by Ritholtz Wealth Management of the S&P 500 between 1927 and 2014 shows the benchmark US index recording positive returns across 88% of all five-year periods. That figure rises to 94% for 10-year periods, while there has yet to be a negative return over a 20-year timeframe. (http://www.schroders.com/fr/sysglobalassets/digital/insights/pdfs/2016/sgis-2016/sgis-investment-outcomes-full-report.pdf).

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?

We agree that it is important to identify sources of value for an entity that are not reflected in its financial statements, and that that entity should report on how those sources of value are managed, sustained and developed. The examples given (employees, customer base, natural resources, intellectual capital etc) are all appropriate.

However, more thought needs to be given to how companies can better account for the various sources of value mentioned here. As recognised in paragraph 7.17, it is important for entities to "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". At present, the key sources of value mentioned in this draft guidance are not incorporated within company balance sheets and their related costs are also externalised. In the meantime, communities and governments are bearing these costs (for example, in the form of pollution-related health issues or state-provided in-work benefits). However, in time, these costs will inevitably come to impact on the profitability of businesses.

In relation to natural capital, for example, the 2016 WWF's Living Planet report found humanity's collective consumption currently exceeds the Earth's biocapacity – the area of land and productive oceans actually available to produce renewable resources and absorb CO2 emissions – by more than 50 per cent.[10] A 2013 report commissioned by The Economics of Ecosystems and Biodiversity (TEEB) for Business Coalition, now known as the Natural Capital Coalition, found that the top 100 environmental externalities cost the global economy around US$4.7 trillion a year in terms of the environmental and social costs of lost ecosystem services and pollution. Corporate profits are then at risk if the costs associated with natural capital are internalised through regulation or an event such as drought (which causes rapid internalisation along supply-chains through commodity price volatility).[11]

As CIMA states in its 2014 report, *Accounting for Natural Capital*, the United Nations Environment Programme's (UNEP) fifth Global Environment Outlook in 2012 concluded that the future success of businesses in a range of sectors, such as transport, tourism, finance and food, will hinge on their ability to manage the major risks posed by climate change, depleted natural resources, the loss of biodiversity and extreme weather conditions. In the pharmaceutical industry alone, UNEP estimated that biodiversity loss, and the subsequent extinction of plant species, could result in the loss of one major drug development opportunity every two years.[12] UNEP's executive director Achim Steiner said that companies that face up to these realities are likely to be the ones that thrive and remain competitive in a rapidly-changing world where factors such as climate change and the dwindling availability of natural resources like water will shape future profit and loss and drive new markets.[13]

We know of few companies which are currently reporting on natural capital in a clear and comparable way. These externalised factors need to be factored into company assessments of value, so they are priced into the market. Investors should be informed about which companies are forward-thinking and will thrive over the long term. As discussed in question 3

---

[10] WWF (2016). *Living Planet Report 2016*. Available from: https://www.worldwildlife.org/pages/living-planet-report-2016 [accessed 23 October 2017].

[11] TEEB (April 2013). *Natural Capital At Risk: The Top 100 Externalities Of Business*. Available from: http://naturalcapitalcoalition.org/wp-content/uploads/2016/07/Trucost-Nat-Cap-at-Risk-Final-Report-web.pdf [accessed 23 October 2017].

[12] CIMA (May 2014). *Accounting for Natural Capital*, p6. Available from: https://www.cimaglobal.com/Documents/Thought_leadership_docs/Sustainability%20and%20Climate%20Change/CIMA-accounting-for-natural-capital.pdf [accessed 23 October 2017].

[13] Ibid, p6.

above, we need to use formal frameworks to ensure that companies are reporting on these areas. The Climate Disclosure Standards Board's Framework for reporting environmental information & natural capital could be used in this context.[14]

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

Not answered.

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?

We agree that it is helpful to emphasise (in paragraph 7.31) that the matters listed in the Act should not be considered in isolation but should be considered when determining the entity's strategy and business model, principal risks and uncertainties and KPIs.

At the FRC roundtable review of the Strategic Report Guidance on Friday 46 May 2017, Matt Shardlow (Chief Executive of Buglife) spoke about the impact of pesticides on the wider environment and how this is being discussed in annual reports. He commented that some supermarkets are mentioning concerns about how the decline of bees could affect their supply chain but some are still failing to, although this issue could cause major problems for their suppliers. Pesticide companies are only talking about 'good things they are doing' rather than the impact they are having on the world. He commented that companies need to think about both:

- the impact of the company on externalities; and
- the impact of externalities on the company.

We are pleased to see that paragraphs 7.33 and 7.34 mention the link between these two aspects of non-financial reporting. However, we feel more could be said here to ensure that companies report on this effectively. As stated at paragraph 4.2 of the draft guidance, "[*c*]*ompanies do not exist in isolation; they need to build and maintain relationships with a range of stakeholders in order to generate and preserve value".* Providing an example like the one above may be useful to illustrate the depth and detail of reporting which companies will need to undertake to demonstrate how they are positioned within the broader economic picture.

To continue analysing the above example, supermarkets need to look at what effects the decline of pollinating insects may have on their supply chain. However, they also need to explore how they can work with their suppliers to ensure that pesticide use does not adversely affect insect biodiversity (and what role the cost pressures often placed on suppliers by supermarkets may play in this equation). We would recommend working with a civil society organisation that specialises in company reporting in a particular sector to develop a brief case study for inclusion (as a new paragraph 7.35) in the strategic report guidance. Again, asking companies to report against external reporting frameworks (in this example, a natural capital framework) is crucial to ensure they are reporting in a rigorous and comparable way.

[14] CDSB (June 2015). CDSB Framework for reporting environmental information & natural capital. Available from: https://www.cdsb.net/sites/cdsbnet/files/cdsb_framework_for_reporting_environmental_information_natural_capital.pdf [accessed 23 October 2017].

If the FRC can get the guidance to work well, company reporting will be more effective and risks better understood by shareholders, who can allocate capital and steward companies for the long term.

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

Not answered.

Summary of recommendations

1. Section 4 should include a statement emphasising that the strategic report is a tool for shareholders to use in selecting, retaining and stewarding their investments in companies, not information for the sake of information.

2. The FRC should ask all companies to report against the key areas of non-financial information which are applicable across all sectors. The European Federation of Financial Analysts Societies (EFFAS) has identified nine ESG topics as applicable to all sectors and industries:
   a. Energy efficiency;
   b. Greenhouse gas (GHG) emissions;
   c. Staff turnover;
   d. Training & qualification;
   e. Maturity of workforce;
   f. Absenteeism rate;
   g. Litigation risks;
   h. [Anti-c]orruption [and anti-bribery];
   i. Revenues from new products.[15]

3. In addition to this, the FRC should also ask companies in specific sectors to report against external reporting frameworks. We suggest that these should cover, but are not limited to, the following:
   a. Other environmental matters (for example, natural capital management);
   b. Further relevant data on the company's employees;
   c. Other social matters (for example, supply chain issues, consumer protection and animal welfare); and
   d. Respect for human rights (for example, indigenous rights and conflict minerals).

4. The FRC should ask representatives from specific business sectors and the civil society organisations that focus on these sectors to recommend reporting frameworks for each of the issues/sectors in point 3.

[15] The European Federation of Financial Analysts Societies (January 2014). *KPIs for ESG*. Available from: http://ec.europa.eu/DocsRoom/documents/1547/attachments/1/translations/en/renditions/pdf [accessed 23 October 2017].

5. The FRC should develop a more detailed assessment of what could be meant by ‘long term’. This could involve including the following statement at the end of paragraph 5.4: *“Some shareholders may have investment horizons of up to 40 years. You should think about principal risks and uncertainties that may be material over a number of different time horizons and report on these variables in the strategic report. This could be divided into 5-year time periods, i.e. ‘Over 5 years’, ’Over 10 years’, ’Over 15 years’, ’Over 20 years’.”*

6. The FRC should draw a clearer link between the impact of a company on externalities and the impact of externalities on the company. We would recommend working with a civil society organisation that specialises in company reporting in a particular sector to develop a brief case study for inclusion (as a new paragraph 7.35) in the strategic report guidance.

As mentioned above, we would be pleased to meet with the FRC to discuss how our workforce data disclosure project methodology could be of use in this area, together with any other points of interest in our response.

Yours sincerely,

Rachel Haworth

APPENDIX

The Workforce Disclosure Initiative (WDI) programme was launched in 2016 by ShareAction and Oxfam, funded by the UK Department for International Development. The programme allows institutional investors to request comparable workforce data from listed companies on an annual basis. The WDI is modelled on the Carbon Disclosure Project and builds on existing reporting standards such as the Global Reporting Initiative, the Sustainability Accounting Standards Board and the Corporate Human Rights Benchmark.

The WDI survey questions cover the following areas:

- Workforce Composition: headcount, gender composition, contract types, wage levels, pay ratios, gender pay gap.
- Workforce Stability: turnover, supplier turnover and recruitment practices.
- Workforce Development: training, progression, capacity building.
- Workforce Engagement: Occupational health and safety, mental health, grievance mechanisms, discrimination and harassment, whistleblowing, freedom of association and/or collective bargaining, engagement surveys.

Investors have sent the pilot year's WDI survey to 75 companies, including the majority of the FTSE 50 and a selection of mega-cap firms on other global exchanges. An analysis report on trends will be published in Q1 2018. The number of companies surveyed will grow substantially year on year. Ultimately, the goal of the WDI is to improve the quality of jobs for employees in companies' global operations and for workers in their supply chains.

More information can be found at https://shareaction.org/wdi/.