

EXPLANATORY MEMORANDUM TO
THE COMPANIES ACT 2006 (STRATEGIC REPORT AND DIRECTORS' REPORT)
REGULATIONS 2013

2013 No. [XXXX]

1. This explanatory memorandum has been prepared by the Department for Business, Innovation, and Skills (BIS) and is laid before Parliament by Command of Her Majesty.

2. Purpose of the instrument

2.1. These Regulations aim at simplifying and restructuring companies' narrative (non-financial) reports by amending the Companies Act 2006 ("the 2006 Act") to create a separate strategic report to replace the existing requirement for a business review. They will also remove some reporting obligations from all companies and require quoted companies to make some additional disclosures. The Regulations will also provide that the strategic report rather than a summary financial statement can be sent to members who do not wish to receive the full set of accounts and reports.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None. The amendments to the Companies Act have been approved by Parliamentary Counsel.

4. Legislative Context

4.1 These Regulations make amendments and additions to the Companies Act 2006 (c.46) ("the Act"), the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (S.I. 2008/410) and to the Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 (S.I. 2008/409).

4.2 The Regulations amend Part 15 of the 2006 Act to repeal section 417 (business review) and remove it from the directors' report, and to insert new provisions (sections 414A to 414D) requiring the preparation of a strategic report containing substantially the same material.

4.3 The Regulations amend Schedule 7 to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 to introduce reporting requirements for UK quoted companies (as defined in section 385 of the 2006 Act) on their greenhouse gas emissions as defined in the Climate Change Act 2008.

4.4 The Regulations amend both Schedule 7 to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (S.I. 2008/410) and

Schedule 5 to the Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 (S.I. 2008/409) to remove some disclosure requirements that have become superseded by later legislation or provide no meaningful disclosure.

4.5 The Regulations amend section 426 of Part 15 of the 2006 Act (option to provide summary financial statement). Companies will no longer be required to prepare a summary financial statement to submit to members who elect not to receive copies of the full accounts and reports, but instead in those circumstances companies will be able to send a copy of the strategic report. In that case, new section 426A provides for certain supplementary material to accompany the strategic report for the information of members.

5. Territorial Extent and Application

5.1 This instrument applies to all of the United Kingdom

5.2 The Northern Ireland administration has agreed that, while company law remains a transferred matter within the legislative competence of the Northern Ireland Assembly, the Companies Act 2006 should apply to the whole of the United Kingdom

6. European Convention on Human Rights

The Minister for Employment Relations and Consumer Affairs has made the following statement regarding Human Rights:

In my view the provisions of the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013 are compatible with the Convention rights .

7. Policy background

- *What is being done and why*

7.1 One of the strengths of the UK corporate governance system is the power shareholders have to challenge their directors and hold them to account. The primary source of information they have to do this is the annual report.

7.2 Over the years, greater emphasis has been placed on the narrative (non-financial) section of the annual report, which aims to explain and put into context the financial information. There have been a number of initiatives that have added to the complexity and length of annual reports.

7.3 There is growing concern that the narrative section of the report has become unhelpfully cluttered. Those important messages used by shareholders to assess the performance of their company are being lost in the mass of textual information. In addition, existing provisions in the law often do not match current best practice in reporting or shareholders' needs.

7.4 In the Coalition Agreement of 2010, the government made a pledge to improve the quality of annual reporting and reinforced this in the Growth Review of 2011. The proposed Regulations fulfil this commitment.

7.5 The suggested restructure and simplification of the reports aims at giving all stakeholders, whether potential shareholders or existing shareholders, the information they need in a clear and effective way so they can be active stewards of the companies they own.

7.6 In addition to the restructuring of the report, the instrument will add disclosures to help shareholders' assess the performance of their companies. The first is the number of men and women on their board, in senior management positions and in the company as a whole. This will implement some of the recommendations by Lord Davies of Abersoch in his review of board diversity in 2011.

7.7 The regulations also add a requirement to disclose human rights issues, a significant move from an otherwise implicit assumption. Companies would be expected to report on any human rights issues, where necessary for an understanding of the development, performance, and position of the company's business.

7.8 The final disclosure in the regulations is the companies' greenhouse gas (GHG) emissions, from activities for which the company is responsible. This disclosure originates in the requirements of the Climate Change Act 2008, section 85.

- *Consolidation*

7.9 None

8. Consultation outcome

8.1 The Department for Business has consulted twice on the issues surrounding narrative reporting. The first, *The Future of Narrative Reporting* published in August 2010 sought views on the problems with the current reporting framework. This consultation ran for 12 weeks between 2 August and 19 October 2010, receiving 89 responses.

8.2 The majority of responses were received from companies and business representative bodies, lawyers and accountants. However responses were also received from non-Governmental organisations and Trade Unions

8.3 Many felt that although UK companies are producing high quality reports that there was room for improvement. Many noted the complexity and overlapping requirements of the current regime that pointed strongly to the need for a more thoroughgoing look across the whole of the narrative reporting landscape.

8.4 A number of respondents highlighted how the different information needs of shareholders, regulators, and wider stakeholders, led to overly complex and long annual reports. It is challenging to define what constitutes relevant data, but it has emerged a great interest in being able to compare companies' reports, to facilitate performance analysis in specific areas.

8.5 In response to these results, BIS issued a second consultation, *The Future of Narrative Reporting: Consulting on a new reporting framework*. This ran for 12 weeks between 19 September 2011 and 25 November and received 116 responses.

8.6 The majority of responses came from businesses and shareholder representative organisations. Additionally, responses were received from non-governmental organisations, trade unions, lawyers, and accountants.

8.7 BIS sought views on proposals to replace the current Director's Report containing Business Review with a Strategic Report and an Annual Directors' Statement (ADS), a supporting document for the strategic report. BIS suggested that ADS could be in a prescribed format so that those shareholders who needed to could compare company performance in specific areas. We also suggested that this document could be placed online.

8.8 Feedback from this consultation was broadly supportive of the intent of the BIS proposals, but critical of some of the suggested changes to the framework, in particular the ADS.

8.9 In regards to the greenhouse gas emissions reporting requirement, the Department for Environment, Food and Rural Affairs (DEFRA) consultation ran from 11 May 2011 to 5 July 2011 and received 2018 responses, with the majority from individuals and companies; however, responses were also received from not-for-profit organisations, campaigning organisations, shareholders and local authorities.

8.10 The consultation sought views on which companies should be required to report their emissions and how they should approach this. DEFRA suggested one voluntary and three regulatory options. These would capture all large and quoted companies and those companies whose electricity consumption exceeded a threshold respectively.

8.11 There was broad support for introducing mandatory reporting for all companies. However, because of the Government's commitment to reduce the regulatory burdens, DEFRA Ministers decided to mandate for quoted companies only, due to the uncertainty of the costs and benefits and the consequent administrative burden. Following a review in 2015, DEFRA will deliberate whether to expand the mandate to large unquoted companies.

9. Guidance

9.1 BIS is not planning to produce guidance on the matters covered by these Regulations but the Financial Reporting Council (FRC) is currently working to update its guidance to take into account the new framework. To support the introduction of the requirement to report on greenhouse gas emissions DEFRA will issue supporting guidance.

10. Impact

10.1 The impact on business is a small reduction in the cost of producing an annual report. The requirement to report on GHG emissions will create a small burden for business. There is no impact on charities or voluntary bodies

10.2 The impact on the public sector is that there will be small ongoing costs to the Financial Reporting Council, the regulatory body for annual reporting.

10.3 An Impact Assessment for both policies is attached to this memorandum and will be published alongside the Explanatory Memorandum on the OPSI website.

11. Regulating small business

11.1 The legislation will apply to small companies who choose not to apply the small companies' exemption available in The Act.

12. Monitoring & review

12.1 The BIS Impact assessment commits to a review of these regulations in 2018 and the regulations will be reviewed by DEFRA in respect of greenhouse gas emissions (GHG) in 2015

12.2 The review will consider if the reforms to the narrative reporting framework have led to companies producing concise clear reports. In considering this the review could look at:

- Shareholder perceptions of the new reporting framework
- The level of enforcement activity undertaken by the FRC
- The quality of disclosure made especially on strategy and business model
- The length of annual reports

12.3 The review will include an analysis of the perceptions of preparers and users of annual reports on the changes. Success will be an improvement of engagement between companies and shareholders and surveys showing an improvement of disclosure in annual reports.

12.4 In terms of the GHG reporting, the review will consider the number of shareholders making use of the information, the costs, and benefits to companies, the level of enforcement activity undertaken by the FRC and a reduction in emissions.

12.5 The review will include quantitative and qualitative research with companies and shareholders, and econometric evaluation of emissions reduction and an analysis of these results

13. Contact

Mark Jackson at the Department for Business Innovation and Skills can answer any questions in relation to the reforms to the Narrative Reporting Framework. He can be contacted on 020 7215 0352 or mark.jackson@bis.gsi.gov.uk

Davinder Lail at the Department for Environment, Food and Rural Affairs can answer queries regarding reporting on Greenhouse Gas emissions. She may be contacted on 020 7238 3048 or davinder.lail@DEFRA.GSI.GOV.UK