Institute of Business Ethics

Response of the Institute of Business Ethics to the Financial Reporting Council consultation on Amendments to Guidance on the Strategic Report

General Comments

The Institute of Business Ethics is an educational charity dedicated to the promotion of high standards of business behaviour based on ethical values. We believe that the way companies communicate is essential to the maintenance of high standards both because it facilitates monitoring and because it helps them assess their own performance. We are therefore happy to be able to reply to this consultation.

Generally we are supportive of the changes proposed, especially the emphasis on the connection between long termism, attention to stakeholder relations and value creation.

We also support the proposed disclosure around Section 172 of the Companies Act and look forward to the government's regulatory proposals in this respect. In our answers to Questions 2 and 3 we set out our view that this should take the form of a statement by the chairman rather than a general statement by the company or even its board.

A personal statement is likely to be less granular and more authentic. It should focus on the steps taken by the chairman to ensure the board takes account of Section 172, and should also refer to major decisions taken during the year.

That said, we feel there is room for clarification in two areas. First we believe the guidance is insufficiently clear about the importance of establishing a clear set of values as a prelude to identifying the purpose of the business which in turn leads on to the business model and strategy. Values will inform the purpose and business model, even if they are not consciously expressed. For example a different purpose will emerge if the founders' values are concerned with delivering value to customers than if they are concerned with finding an opportunity to overcharge customers because they can get away with products of poor quality.

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It is better for businesses and those who lead them to be aware of what their values are and be comfortable with them from the outset. In our answer to question 7 we therefore recommend that the wording of paragraphs 7.5 to 7.10 as well as paragraph 7.12 be reviewed.

Second, we are concerned at what appears to be a general trend to give boards primary responsibility for engagement with stakeholders, whereas this should normally be a task for the executive. Boards have to be aware of the expectations of key stakeholders, and this may require some direct contact with the key stakeholders, but their principal task is to oversee the relationship between the company and its stakeholders. Otherwise there is a risk of the board second-guessing the management and micro-managing. Paragraph 7.52 should therefore be revised. It is not, or should not be correct that the board manages the company. The executive is responsible for that, while the board oversees the processes. This is more than just semantics.

The paragraph as drafted implies a profound change in our understanding of the role of boards which we consider could be seriously detrimental.

Specific answers

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?

Yes. We support the affirmation of the purpose of the Strategic Report as set out in the Companies Act 2006, the objective of keeping the Strategic Report as a single cohesive document and the introduction of "encouraged content."

Question 2. Do you support the enhancements that have been made to Sections 4 and 7 of the Guidance to strengthen this link [to Section 172 of the Companies Act]

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

While we are waiting for the Government to propose regulations for reporting around Section 172, the Guidance cannot be definitive. We support the specific references to Section 172 in Section 4 of the draft guidance, together with the explicit connection made between the generation of value and the relationship between companies and broader society as set out in Paragraph 4.2 of the draft guidance.

However we believe it would eventually help to go further and encourage a specific statement by the Chairman on how he or she has ensured that the board has taken account of Section 172 in specific areas, including:

- setting objectives for directors individually
- setting priorities for the board as a whole
- decision-making
- skills development and board evaluation

There is a need for granularity in these statements, which might otherwise become standardised boiler-plate, written by lawyers. A personal statement by the chairman is always likely to be more authentic than a general statement by the company or its board. The statement should include specific reference to how Section 172 was taken into account in key decisions during the year, such as acquisitions, major new investments and restructuring.

We support the use of 'encouraged' content in Section 7 of the draft guidance. However, some of this (notably that attached to Paragraph 7.18) could usefully be expanded to include expectations that companies will report on the distinction between stakeholders who have an impact on its affairs and those on which its operations might have an impact. Both groups will need to be taken into account, not just those which have a direct impact on its affairs.

It is critically important that companies are aware of the expectations of those on whom, they are having an impact even when this is indirect. Good practice would be to have a detailed stakeholder map. This would be part of the Strategic Report and linked to the risk register.

Also, the Chairman's statement should talk about how the board *oversees* relationships with key stakeholders that may predominantly, and rightly, be undertaken by the executive. The board should not duplicate this work in a way that second-guesses the executive but it should satisfy itself that

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appropriate relationships are in place and are working in line with expectations.

Boards will need to have contact with key stakeholders in order to understand their concerns at first hand but, apart from the shareholders to whom they are directly accountable, they are not normally the primary interlocutors and they should be clear about the nature and purpose of their engagement and explain this in their statements. For example, the chairman of a regulated entity might meet the chairman of the regulator periodically with the purpose of ensuring that the operational relationship between the two sides is working properly.

Question 4. Do you agree with the draft amendments to Section 5 [on materiality]?

Yes. In particular we welcome the reference to long term factors in the new paragraphs 5.3 and 5.4. This is consistent with Section 172 of the Companies Act.

Question 5. Do you have any suggestions as to how the Guidance could encourage better linking of information in practice, or common types of disclosures that would benefit from being linked?

We support the proposed changes.

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

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

We do not believe the revised Guidance is clear enough about the relationship between values, purpose, business model and vision. It is important for the company to be clear about its purpose. Long term success depends on having a purpose which involves delivering something that society wants and needs. Otherwise the franchise will not be secure.

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This goes beyond the generation of financial profit for shareholders, which will ultimately in any case become impossible if society feels it is receiving no value in return or even that value is being extracted.

Whether they are articulated or not, a company's purpose will reflect the values of those that created it. The values are not derived from the purpose or strategy. They inform both from the outset and send a clear signal about *how* the entity intends to achieve its objectives as well as what those objectives are.

It follows that where a company talks about purpose, strategy and vision, it should start by saying what its values are. This leads on to the description of how the values led to the definition of purpose, and the description of purpose leads on to the business model, which is the means by which the purpose is delivered, while the vision is the end-destination. Paragraphs 7.5 to 7.10 could perhaps be reviewed in this light.

Specifically we suggest redrafting the first sentence of Paragraph 7.6 to read:

"An entity's purpose identifies the contribution it intends to make both in the narrow and broader social context."

Also we would suggest that the final sentence of Paragaph 12 be redrafted as follows:

"There should be alignment between company values, purpose, business model and vision."

We support the clear link in this section between the expected disclosures and the generation of long term value for both shareholders and other stakeholders which are interconnected.

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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?

Yes, especially as they are placed in the context of value generation.

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

We have not identified any issues that are not addressed above. However, with one caveat, we would like to take the opportunity to support the new paragraph 7.52. Where companies have clearly stated their values and purpose, it makes sense for them to select the way in which the executive manages and the board oversees the business. We believe it is right that the comparability of the KPIs between industry peers should not override their effectiveness in this respect. Our caveat is that we feel the reference to the way the board "manages" the business is too compressed. Boards do not manage. They oversee. This should be reflected in the text.

Finally a small drafting point related to the example attached to new Paragraph 7.27. The new sentence should refer to whether UK standards are *adopted* throughout its supply chain. This fits the context better than the word *permeated* in the draft.

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