PREPARE, IDENTIFY, REPORT
A FRAMEWORK FOR PREPARING A SECTION 172 STATEMENT

For periods beginning on or after 1 January 2019, all large companies must include a separate statement within their strategic report that explains how the directors have had regard to broader stakeholder interests when performing their duty under section 172 of the Companies Act 2006 to promote the success of the company for the benefit of its members as a whole.

This flyer looks at this requirement more deeply and sets out a framework that can be used to help draft a high quality statement.

Background

The past few years has seen a lot of focus and debate on UK corporate governance. A decline in public trust in business has been caused in part by high-profile business failures, accusations of excessive executive pay, unethical tax avoidance by multinational businesses and deteriorating relationships with employees over pay and contractual terms. These factors have led to Prime Ministerial statements, select committee inquiries, public consultations, a government green paper and, ultimately, to changes in legislation, stock exchange rules and governance codes.

Many of the matters noted above have resulted from decisions made in the board room and their effects have been felt by the employees, pension scheme members, customers, suppliers and other stakeholders, as well as shareholders, the interests of all of whom the directors have a statutory duty to consider when making a decision. It is in this context that the widest-ranging of the new reporting requirements has been introduced for large companies: The Section 172 Statement, which must be included in the annual report of all large companies (as defined in the Companies Act 2006).

What does section 172 require and is reporting on it new?

Under section 172, directors have a duty to promote the success of the company for the benefit of the members as a whole and, in doing so, they should have regard to (amongst other matters) six specified areas that relate, by-and-large, to wider stakeholder interests:

These six areas are not new – they have featured in the Companies Act since 2007 - and nor is the concept of reporting on them, as the purpose of the strategic report has always been to inform members how the directors have performed their duties under section 172. However, strategic reports have traditionally concentrated on the performance of the company in the year – perhaps with a brief reference to the forthcoming year – and describing principal risk, rather than dealing specifically with the other aspects of the directors' duties. This is particularly the case for companies that are not caught by the more stringent 'non-financial reporting' requirements that apply to Quoted companies and Large Public Interest Entities.

The introduction of the Section 172 Statement seeks to address this by adding a new explicit requirement for all large companies to explain how these six areas of broader stakeholder interests (that are identified in section 172(1)(a)-(f)) have been taken into account by the directors during the year. The emphasis on these matters is an acknowledgement that most of them will be of direct relevance to a company's longer-term viability and prospects.

Where does the Section 172 Statement go?

The Section 172 Statement should be a separately identifiable statement within a company's strategic report. It must also be published on a website. If the company does not have its own website, the statement may be included on a parent's website as long as the company to which it relates is clearly identified.

What information should be included in a Section 172 Statement?

The legislation itself does not specify the information or level of detail to be included in the statement, at least in part because it is expected that this should be bespoke to the company. However, both the Department for Business, Energy and Industrial Strategy (BEIS) and the Financial Reporting Council (FRC) have issued some general guidance, which suggests that the Section 172 Statement should usually include information on the following:

- The issues, factors and stakeholders the directors consider relevant in complying with section 172(1)(a)-(f) and how they have formed that opinion.
- The methods the directors have used to engage with stakeholders and understand the issues to which they must have regard.
- The effect of that regard on the company's decisions and strategies during the year.

This means that a simple statement confirming the directors' compliance with section 172 or a general description of governance processes is unlikely to be considered sufficient to meet the legislative requirement. The third bullet in particular indicates that the statement should be updated annually and should refer to matters that have been the subject of board attention during the year.

How should we go about preparing our first Section 172 Statement?

Whilst the three bullets above do provide a structure that will aid the drafting a Section 172 Statement, some additional process may be helpful in order to focus directors' minds on the most important matters and information to report. The framework below is intended to provide further assistance to directors when drafting a Section 172 Statement. It is split into three stages: **Prepare**, **Identify** and **Report**.

PREPARE

- **Read the BEIS[1] and FRC[2] guidance** - The material published by BEIS and the FRC is a good indication of regulator and investor expectations regarding the nature of information that should be included in a Section 172 Statement
- **Identify all group companies within the scope of the requirement** – A Section 172 Statement must be prepared by all large companies, as judged under the size limits and eligibility criteria set out in the Companies Act 2006, including subsidiaries in their individual accounts
- **Determine whether the company is within the scope of the associated directors' report requirements** - The associated directors' report disclosures have a slightly narrower scope than the main requirement. Where they must be provided, it may be more efficient to include them in the separate Section 172 Statement and cross reference to that from the directors' report
- **Decide how to publish the statement** - A company must publish the Section 172 Statement on its website as well as including it in its annual report. In order to achieve this, it has the option of publishing either a standalone Section 172 Statement, the whole strategic report (with supplementary material, as allowed under s426 of the Companies Act 2006) or the entire annual report on its website (AIM listed and quoted companies are already required to publish their annual reports on their websites). This document can also be included on a parent's website, rather than a website that is specific to an individual subsidiary, so long as the company to which it relates is clearly indicated
- **Understand the company's key stakeholders** - The directors can only comply with their section 172 duties if they have a full and up-to-date appreciation of all the stakeholders with whom the company might interact or whom it might affect:
  - Think beyond the more obvious stakeholders, such as shareholders, employees, suppliers and customers. This might include the workforce on a wider basis (eg contractors and agency staff), pension schemes, the local community or those affected by the company's environmental impact
  - A stakeholder map may be helpful to facilitate this process
  - Consider whether key stakeholders, or the relative importance of them, differ from company to company with a group
  - Revisit the list of stakeholders on a regular basis as the business evolves.

1. The Companies (Miscellaneous Reporting) Regulations 2018 Q&A (November 2018), Section D
2. Guidance on the Strategic Report (July 2018), Section 8

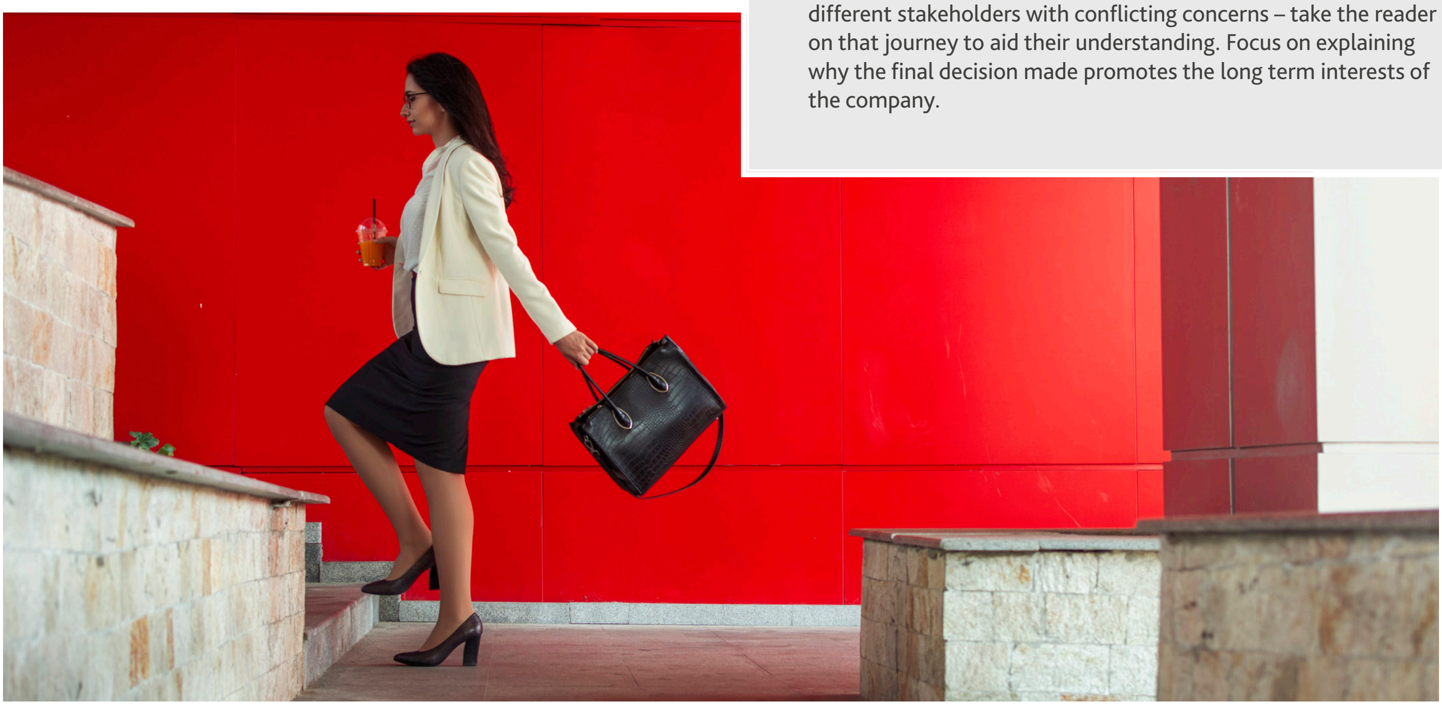
IDENTIFY

- **Identify the key decisions made during the year** - What decisions affected the business, or a key stakeholder group, in a significant way during the year or will affect it in a significant way going forwards? We would expect these to be the decisions the board spent a substantial amount of time considering and they are likely to be documented in board minutes and papers
- **Identify the stakeholders affected by each key decision** - Which stakeholders were, or will be, most affected by each key decision identified? Bear in mind that not all major decisions affect stakeholders in the same way or to the same degree.
- **Reflect on how the key decisions were made** - How were the possible effects of a decision understood? Exactly how did the directors consider the relevant stakeholders when making their decision and what practical steps were taken to ensure the views of all relevant parties were understood? Did consideration of these matters affect the decision when it was made; for example, were plans altered as a result of this process?
- **Consider the longer-term effects of the decision** - The effect of some decisions may be different over the short and long term. Where this was the case, how were the conflicting factors considered and balanced?

REPORT

For each key decision in the year…
DO:

- Describe the methods used for identifying the key stakeholders relevant to each key decision - A brief general disclosure may be appropriate but a more detailed description of specific steps taken may also be necessary for key decisions taken in the year
- Describe the processes for engaging with key stakeholders and understanding the issues relevant to each key decision - Again, a brief general disclosure may be appropriate but a more specific description of steps taken may also be necessary to ensure that the Section 172 Statement is tailored to the key decisions taken in any given year
- Ensure that disclosures are concise but comprehensive – The disclosures should cover all material aspects of s172(1)(a)-(f) but avoid the temptation to write about a matter specified in s172 if it has limited relevance to a specific decision.
- Acknowledge conflicts between stakeholder interests and explain how they influenced the decisions made - These conflicts may exist between the long-term and short-term good of the company, between shareholders and employees or between groups of shareholders with different agendas. For key decisions where stakeholders might have different perspectives, explain the view of each group of stakeholders and how this influenced the decision making process. Making a decision for the long term future of the company is never easy, not least when there are different stakeholders with conflicting concerns – take the reader on that journey to aid their understanding. Focus on explaining why the final decision made promotes the long term interests of the company.



DON'T:

- Forget to show how the longer-term effects of key decisions were considered - Whilst most strategic reports typically focus on the current company position and the expected performance over the next financial year, for directors to show they have complied with their section 172 duties, the discussion on the future ramifications of a decision may need to stretch further into the future
- Talk in general terms or use the same content for every subsidiary - Try to avoid sweeping statements like 'the directors have regard to all stakeholders…' and, instead, be specific about the different processes used by the directors to engage with each stakeholder group
- Place over-reliance on cross-referencing and linkage to different parts of the annual report - Information in the Section 172 Statement is likely to relate to other parts of the strategic report, directors' report and corporate governance statement, including disclosures about the business model, principal risks and future outlook. Whilst it is perfectly acceptable to seek a better 'flow' to the annual report and to reduce duplication, it is important that the Section 172 Statement meets its statutory objective on a stand-alone basis. Particular care should be taken in this respect when the directors intend to publish a standalone Section 172 Statement on the company website
- Provide disclosure for disclosure's sake – Section 172 Statements should be meaningful and informative and should deal with matters that are of strategic importance to the company in question; the level of detail should be consistent with the size and complexity of the business.

Conclusion

The decline in public trust in business has fuelled an increased focus on how directors run the company and the increasing level of scrutiny we have witnessed over the last few years shows no sign of slowing down. Embracing the Section 172 Statement requirement means giving a level of detail necessary for all stakeholders to truly understand the directors' decisions-making process. It will show the complexities of running a company with multiple stakeholders and is an opportunity to give readers a real insight into how directors have fulfilled their stewardship responsibilities and met their statutory duties. Transparent and relevant disclosure on the motives for, and consequences of, key decisions can and should be a key method of addressing the rise of negative perceptions of the quality of corporate governance in individual companies and in the economy more widely.

FREQUENTLY ASKED QUESTIONS

PREPARE

Is there any guidance available for preparing the Section 172 Statement?

Yes. Directors may find the following sources of guidance helpful:

- The Department for Business, Energy and Industrial strategy (BEIS) has published "The Companies (Miscellaneous Reporting) Regulations 2018 Q&A[3]", which includes guidance on the Section 172 Statement and related disclosures
- The Financial Reporting Council's (FRC) "Guidance on the Strategic Report[4]" includes a section with guidance and suggestions for how to prepare the Section 172 Statement
- GC 100 has published "Guidance on Directors Duties – Section 172 and Stakeholder Considerations ", which includes practical steps directors can take to comply with their underlying duties under s172

[3] The Companies (Miscellaneous Reporting) Regulations 2018 Q&A (November 2018), Section D

[4] Guidance on the Strategic Report (July 2018), Section 8

PREPARE

To which entities does the section 172 requirement apply and are there any exceptions?

The requirement applies to all large companies with no exceptions. This means it applies to:

- Parent companies
- Intermediate parents
- Subsidiary companies
- Listed companies
- Quoted companies
- The requirement does not apply to non-companies (eg Limited Liability Partnerships (LLPs)).

PREPARE

What is a "large company" in this context?

The criteria for large companies is the same as it is for accounting purposes, which is set out in the Companies Act 2006:

- Turnover > £36m
- Balance sheet total >£18m
- Average number of employees > 250

Broadly, a company would be within the scope of the requirements if two of the three criteria are met over two consecutive years, or if it is an ineligible company.

For parents/intermediate parents, the group it heads must be considered, irrespective of whether consolidated accounts are prepared. This means that, if the parent appears not to be large by reference to its individual accounts but the group it heads is large or ineligible, it would be within the scope of the requirements.

PREPARE

Are there any other related narrative reporting changes to consider?

Yes. Effective from the same date, further legislative changes require the following related directors' report disclosures:

- All large and medium-sized companies with more than 250 UK employees (including those employed by a subsidiary of the company) must include a statement summarising how the directors have engaged with employees, how they have had regard to employee interests and the effect of that regard, including on the principal decisions taken by the company in the financial year; and;
- All large companies (but, this time, when judged purely from an individual company perspective, rather than considering any group headed by the company in question) must include a statement summarising how the directors have had regard to the need to foster the company's business relationships with suppliers, customers and others, and the effect of that regard, including on the principal decisions taken by the company during the financial year.

These requirements are very similar to the requirements of section 172 and, whilst they are technically directors' report disclosures, the BEIS FAQs note that it is envisaged that many companies will want to incorporate these disclosures into their Section 172 Statement and crossrefer to that statement from the directors' report.

FREQUENTLY ASKED QUESTIONS

IDENTIFY

What do parents, intermediate parents and subsidiaries include in their Section 172 Statements when they prepare only individual accounts?

Where the parent is preparing individual accounts, then the statement should be focussed on decisions taken by directors of the company in question.

If the company is an intermediate parent or a subsidiary, and decisions are made higher up the group that affect the company in question, it may be appropriate to provide more limited disclosure in that company's Section 172 Statement and to include a cross-reference to a Section 172 Statement from a company higher up the group. It is important to note, however, that directors of any companies within a group must still comply with their statutory duty in their own right when applying policies and decisions passed down to them from higher in a group structure. In these circumstances, the Section 172 Statement of the affected company should explain how the directors of that company have become comfortable with their actions in the context of their own s172 duty. It is also quite possible that decisions that affect a company further down a group may be relatively more important to that individual company and its stakeholders than they might be from an overall group perspective; such decision may have been given little or no coverage in the Section 172 Statement of the ultimate parent company and so will have to be described in more detail in the affected company's Section 172 Statement.

IDENTIFY

What do parents/intermediate parents include in their Section 172 Statement when they prepare consolidated accounts?

As is the case with the strategic report itself, the narrative in a Section 172 Statement included within the consolidated accounts of a parent company should cover matters that are of strategic importance to the group as well as the company.

For intermediate parents, the same considerations apply to those described above for intermediate parents and subsidiaries in their individual accounts.

IDENTIFY

What should a Section 172 Statement include if no significant strategic decisions have been made during the year?

Section 172 Statements will vary in content and length from year to year. If this is the case then the statement should include more general content, for example how directors have engaged with stakeholders during the year or what policies and mechanisms are in place to foster business relationships with suppliers and customers. Ultimately, however, a Section 172 Statements should be meaningful and informative and should deal with matters that are of strategic importance to the company in question; the level of detail should be consistent with the size and complexity of the business.

REPORT

If the directors' report disclosures on employees and suppliers, customers and others and not considered to be of strategic importance, must they still be given?

Yes. Companies that are within the scope of the directors' report requirements (remembering that they have a different, more limited, scope than the main Section 172 Statement requirement), must provide those disclosures irrespective of their perceived strategic relevance.

19-10-1724

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