

Baroness Hogg  
The Financial Reporting Council  
5th floor, Aldwych House  
71-91 Aldwych  
London WC2B 4HN

15 November 2013

Dear Baroness Hogg,

### **FRC Consultation: Exposure Draft, Guidance on the Strategic Report**

LAPFF welcomes the opportunity to respond to this consultation document, as part of our continuing dialogue with yourself and FRC representatives. As you know the Forum has been concerned over the last two years about what it sees as the weaknesses in the application of IFRS in the UK's corporate reporting practices, in so far as their application has become de-coupled from the provisions of the Companies Act in terms of materiality and the true and fair view.

LAPFF has been broadly supportive of the objectives in the coalition agreement regarding a form of strategic report. In that context however we have also been concerned that transparency may be lost if the strategic report is a less rigorous report than the current report and accounts, and, where applicable, the current summary financial statements. In our response to this consultation we set out where we have concerns with the method of implementation in both the Regulations and the FRC proposals.

At first sight, the subject of the strategic report, as opposed to the Annual Report, would not appear to necessitate our response to this consultation. However, the first question and illustration 1, which attempt to define the accounts part of the Annual Report, in order to put the strategic report into context, come up against the same accounting standard setting weaknesses inherent in the IFRS Framework.

It may be helpful to illustrate our concerns by our view of the purpose of the annual accounts in law. This in our view of the legal framework is:-

- to discharge the duties of the directors, under audit, which is that the accounts give a true and fair view for the Act, which relates to their fiduciary duties over company property, including fraud, error and permitting a lawful distribution to be made - and if there is a capital raising, the converse: that the accounts are not nursing losses not shown. **For that, the annual accounts are essential.**

- To enable the shareholders to hold the directors to account, which may involve their not being re-appointed. **For this function the annual report is also essential.**

However, the concept of the annual report as stated in question 1 is as follows:-

*“The purpose of the annual report is to provide shareholders with relevant information that is useful for making resource allocation decisions and assessing managements’ stewardship.”*

- In our view the phrase “resource allocation decisions” is meaningless jargon.
- In similar vein, the term “usefulness” simply does not reflect the fact that in our view and our interpretation of Company Law, the accounts are essential for their legal purpose.
- And again we question the phrase “managements’ stewardship”. In the UK the accountability enshrined in Company Law is placed on the directors for which binding votes apply to all directors. In this respect we believe that the model outlined in the consultation document does not accord with the model of governance that the UK Corporate Governance Code itself enshrines.

Nor is the IASB definition of materiality appropriate. The governance model that the IASB is working to (based on a US model of corporate governance) does not envisage materiality on the terms that the accounts, in law, are for. This includes:

- binding votes on director reappointment, and
- binding votes on directors pay, for which the new Regulations in force from 1 October 2013 recognise an “Accounts General Meeting”, i.e. the members receive the accounts in order to vote on the new model of pay approval.

Further to that, there is also a structural problem with the content of the Strategic Report. LAPFF attended a recent consultation meeting at BIS on the new Regulations on pay. We are concerned that currently these Regulations on the Strategic Report do not actually fit with the pay Regulations.

In that meeting the issue was raised by a very large company, which until now has seen the majority of its shareholders receiving summary financial statements, rather than the annual report and accounts.

The problem is that the new Regulations for pay which by law require an 'accounts general meeting', requiring that shareholders receive the annual report and accounts or the summary financial statements containing the accounts. However, the strategic report, which is replacing the summary financial statements (that are currently presented to a true and fair view standard) means that most shareholders will not receive the accounts for the "accounts general meeting".

The powers granted to the Secretary of State in Section 468 Companies Act 2006 (content of Accounts and Reports) and separate powers granted to the Secretary of State in Section 417 (content of the Directors' Report, which recognises the Business Review as dealing with Section 172 general duties to promote the success of the company), seem to have been confused. We are therefore concerned that there does not seem to be any basis in the primary legislation for the powers under Section 417 to eliminate what is required by Section 468 - hence replacing the accounts - altogether.

We thought it would be helpful to this discussion to note the referenced 'UK Corporate Update' from Linklaters<sup>1</sup> also raises the issue that the Strategic Report Regulations do not address the mechanics of obtaining shareholder consent and further Regulations are likely to be required.

There is then a further problem. The director duties under Section 172 are to promote the success of **the company**. However, the financial information in the Strategic Report Regulations relates to the subsidiary undertakings included in the consolidation (Section 414(3)). Given that the company is a different legal entity to its subsidiaries, it is difficult to see how, as the Regulations state Section 414C of the Strategic Report is informing members how directors are discharging their duties to **the company**. In our view as is usual, subsidiaries have different boards, and indeed may be located overseas, and the information being included is relevant to other undertakings where other parties' legal responsibilities lie.

Ironically with regard to greenhouse gas emission reporting, the reverse seems to be happening. Although the Forum has long supported mandatory reporting of green-house-gas (GHG) emissions, the regulations for the Strategic Report only seem to require GHG emission reporting for the company, not for the group as a whole, as the statement that the Strategic Report is dealing with Section 172 CA 2006 'duties to promote the success of the company' maintains.

I realise that we have raised fundamental concerns about the status and compatibility of the proposed Strategic Report with UK Company Law and the preparation of annual accounts for shareholder approval. In light of these fundamental concerns we have decided that responding to the other consultation questions would not be helpful and lead to repetition.

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<sup>1</sup> <http://www.linklaters.com/Publications/Publication1005Newsletter/UK-Corporate-20-June-2013/Pages/New-UK-annual-strategic-report-disclose-human-rights-diversity-greenhouse-gas-emissions.aspx>

Perhaps following the consultation period we should meet to discuss our concerns further if you thought this would be helpful. I realise also that the more fundamental concerns we and other investors have raised about IFRS underpin much of our response to the Strategic Report consultation. I am please to note that the IFRS investor coalition is making progress in this regard with representatives of the FRC of which the Forum remains hopeful.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Ki Q.', written in a cursive style.

Cllr Kieran Quinn, Chair

CC Tessa Younger, Engagement Services Manager, PIRC ([tessay@pirc.co.uk](mailto:tessay@pirc.co.uk))

LAPFF represents the interests of 58 public sector pension fund members, which have combined assets of approximately £115 billion. Its mission is to protect the long-term investment interests of their beneficiaries, by promoting the highest standards of corporate governance and corporate responsibility amongst the companies in which they invest.