CORE response to the Financial Reporting Council Exposure Draft: Guidance on the Strategic Report

CORE is an authoritative and influential network of NGOs, academics, trade unions and legal experts which brings together the widest range of experience and expertise on UK corporate accountability in relation to international development, the environment and human rights.

Our aim is to reduce business-related human rights and environmental abuses by making sure companies can be held to account for their impacts both at home and abroad. We believe that reporting requirements can also drive better strategic understanding within the individual business of the risks and impacts of its core activities in relation to the environment and human rights. In this way an effective and relevant reporting regime can help prevent abuses and support more sustainable business models.

Key points:

- **Good quality guidance is needed to help companies report effectively**
- **The FRC draft Guidance needs to be amended to reflect the Companies Act more accurately**
- **The definition of materiality used in the guidance is too narrow and should be revised**
- **Amendments are needed to reflect good practice in relation to social, human rights and environmental reporting**
- **Particular attention should be paid to providing helpful guidance on reporting on human rights issues**
- **CORE welcomes a chance to talk with the FRC about its suggestions for how the Draft Guidance can be improved.**

Good quality guidance is needed to help companies report effectively

CORE agrees with the Financial Reporting Council (FRC) on the importance of companies preparing a high quality strategic report. However we are concerned that the Draft guidance in its current form will not necessarily support that objective and represents a missed opportunity to help businesses meet the requirements of the revised 2006 Companies Act. We are pleased to have this opportunity to comment on the draft guidance and hope that better engagement between a range of stakeholders with broader experience, including trade unions and human rights, development and environmental NGOs, will contribute to a more useful final text.

The FRC draft Guidance needs to be amended to reflect the Companies Act more accurately

While the FRC Guidance is not mandatory it will be an important reference point for companies and shareholders. However CORE is concerned that the interpretation of the Companies Act 2006 as set out in the draft guidance is unnecessarily restrictive. This could mean that companies reporting in line with the Guidance would not actually be meeting all the legal requirements of the Companies Act.

The purpose of the strategic report, as laid down in the new Companies Act provisions, "is to inform members of the company and help them assess how the directors have performed their duty under section 172 (duty to promote the success of the company)."[1] The text of section 172 of the Companies Act 2006, which defines the scope of this duty, is set out in the Box below.

Box 1: Companies Act 2006, section 172

(1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to —

(a) the likely consequences of any decision in the long term,
(b) the interests of the company's employees,
(c) the need to foster the company's business relationships with suppliers, customers and others,
(d) the impact of the company's operations on the community and the environment,
(e) the desirability of the company maintaining a reputation for high standards of business conduct, and
(f) the need to act fairly as between members of the company.

(2) Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes

(3) The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.

Section 172(1) codifies and clarifies the previous common law and equitable duties to act in good faith in the best interests of the company or to "promote the best interests of the company". The underlying policy objectives of the reformulated directors' duty in section 172(1) was to ensure that companies would be managed more responsibly and in a way that secures their financial success over the longer term and, to this end, to encourage directors to be more inclusive in their decision-making.

[1] See section 414C of the Companies Act 2006 (as amended).

While the factors that directors are supposed to have regard to do not imply any specific duties to those other stakeholder groups (see esp. items (b), (c) and (d) in Box 1 above), directors are now explicitly required to take these interests and issues into account in the way the business is run. The list of factors, not exhaustive, "highlights areas of particular importance which reflect wider expectations of responsible business behaviour".[2] To this extent, section 172(1) was intended to be, according to a 2007 Ministerial Statement, "a radical departure in articulating the connection between what is good for a company and what is good for society at large".[3] The reformulated duty therefore demands more from directors than superficial consideration of the issues. As the Explanatory Notes to the Companies Act 2006 make clear "it will not be sufficient to pay lip service to the factors and, in many cases, the directors will need to take action to comply with this aspect of the duty".[4]

The strategic report is the means by which the directors justify their decision-making to shareholders in light of their duties under section 172(1). This is the place where directors explain to shareholders the ways in which they have taken account of the prescribed (and other) factors and describe the action taken in relation to them. However, the FRC draft guidance largely ignores the statutory purpose of the strategic report under section 414C(1) in its discussions of the "needs of shareholders" and the concept of materiality. For the FRC guidance to adequately support the underlying policy of "enlightened shareholder value", it should be made clear that the "needs of shareholders" and the concept of "materiality" in the selection of material for inclusion in the report are to be understood in the context of the strategic report's statutory purpose, namely, as noted above, to inform members and *help them assess how the directors have performed their duty under section 172 [i.e. to promote the success of the company]*.

Part 2 below makes some suggestions as to the changes that would be needed to the text to ensure that the concepts of "needs of shareholders" and "materiality" are properly linked to the strategic report's statutory purpose, and to properly support the UK Government's objectives in relation to "enlightened shareholder value".

The definition of materiality used in the guidance is too narrow and should be revised

The biggest overarching change that CORE proposes is for the FRC to rethink the definition of materiality which it is currently using within the Draft Guidance.

[2] Companies Act 2006, Explanatory Notes, para. 326. Available at http://www.legislation.gov.uk/ukpga/2006/46/notes/division/6/2.

[3] See *Duties of Company Directors,* DTI, June 2007, 'Introduction and Statement of the Rt Hon Margaret Hodge', copy available at http://www.dti.gov.uk/files/file40139.pdf.

[4] Companies Act 2006, Explanatory Notes, n. 3 above, at para. 328.

In our view, adopting the concept of materiality based on the IFRS definition and then using that as the main factor in deciding what information should be included or excluded within the Strategic Report is a major weakness of the current draft. The guidance on materiality is vague and, as noted above, insufficiently linked to the strategic report's statutory purpose, which is to enable shareholders to assess how directors have performed their duty to promote the success of the company as defined in section 172 of the Companies Act 2006. The top priority for improving the draft is using a better definition of materiality.

Amendments are needed to reflect good practice in relation to social, human rights and environmental reporting

The FRC draft guidance covers many issues previously identified by CORE as necessary for effective and informative narrative reporting, namely, the need for narrative reports to be focussed, relevant, concise, balanced and evidence-based, and to complement and supplement the information in the company's financial statements.[5] However, the guidance currently provided in relation to reporting on environmental, employee, social, community and human rights issues is scant.

Unlike the Reporting Standard created for the Operating and Financial Review, the FRC draft guidance provides no illustrative examples of potentially useful KPIs to help track progress in relation to social, environmental and human rights issues. The need for and usefulness of KPIs is not given sufficiently strong emphasis in the sections relating to social, environmental and human rights reporting (see sections 6.64 to 6.67). Use of quantitative (rather than qualitative) KPIs where possible is generally regarded as best practice, yet this distinction, and the importance of using quantitative KPIs wherever possible, is not mentioned in the guidance.

Reporting on social, environmental and human rights issues are treated as an afterthought or an "add on", rather than integral to discussions on risks and uncertainties and trends and factors likely to affect future development, performance and position. The linkages between these issues need to be more fully explored and emphasised in the Guidance.

Track changes are suggested below to try to address some of these issues, although some of the points above can only be fully addressed with further interpretative guidance. The FRC should consider further sectoral guidance, which would include illustrative examples of potentially relevant KPIs, along the lines of the methods used by the Global Reporting Initiative.

[5] See Corporate Responsibility (CORE) Coalition, *Simply Put: Towards an effective UK regime for environmental and social reporting by companies*, May 2012. Copy available from http://corporate-responsibility.org/simply-put-towards-an-effective-uk-regime-for-environmental-and-social-reporting-by-companies/.

Particular attention should be paid to providing helpful guidance on reporting on human rights issues

The explicit reference to human rights issues in the regulations, as one of a group of specific issues that must be reported on where relevant to a company's future development, performance and position, is a new development. Compared to some aspects of environmental reporting (such as waste, water use and GHG emissions) corporate reporting on human rights issues is not well developed. Therefore proper guidance on human rights reporting is of key importance in raising standards, ensuring that the policy objectives of enlightened shareholder value are met and that directors do indeed pay more than "lip service" to these issues. At the very least, the FRC should follow the example of the Global Reporting Initiative and provide directors with an indicative list of issues to consider in preparing their reports.[6]

CORE welcomes the fact that "human rights issues" are now explicitly mentioned in the Companies Act. We are pleased that in its review of reporting requirements BIS did not ignore the global developments in relation to business and human rights since 2006, for example the adoption of the UN Protect, Respect, Remedy Framework by the Human Rights Council and the Government's commitment in 2011 to implement the Guiding Principles on Business and Human Rights. In our view, an integrated approach to reporting requirements is much better than bombarding companies with separate initiatives. Therefore it is disappointing that there is no reference in the draft Guidance to the UN Guiding Principles or concepts such as human rights due diligence which may be very helpful to those preparing reports on human rights issues for the first time. In addition to adding references within the text of the guidance, it also seems useful to signpost companies to additional sources of information and expertise in this area.

CORE welcomes the opportunity to engage directly with the FRC about its suggestions for how the Draft Guidance can be improved

Section 2 of this response outlines some suggested track changes and practical examples of amendments to the draft text which would begin to address our concerns outlined above. However we believe that direct discussions between CORE members and the FRC are also needed. As a Coalition we are keen to meet with the FRC to discuss the ways in which the Draft can be strengthened so that the final Guidance is as useful and effective as possible.

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[6] See Global Reporting Initiative, *G4 Sustainability Reporting Guidelines, Reporting Principles and Standard Disclosures*, copy available at https://www.globalreporting.org/resourcelibrary/GRIG4-Part1-Reporting-Principles-and-Standard-Disclosures.pdf, p. 9.

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Part 2: CORE's suggested amendments to the existing consultation text:

Summary to the Draft FRC Guidance

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[draft] Guidance on the Strategic Report
Summary

(v) The overriding objective of narrative reporting is to provide information on the entity, insight into its main objectives and strategies, the principal risks if faces including ESG risks; and to complement, supplement and provide context for the related financial statements.

(vi) The strategic report is an integral part of narrative reporting and is the focal point of the [draft] guidance. The [draft] guidance includes sections on the application of materiality to the strategic report, communication principles, and content elements.

(vii) The guidance recommends that ~~only~~all information that is material to shareholders should be included in the strategic report. However, ~~i~~Immaterial information should be excluded as it can obscure the key messages and impair understandability. Materiality must be understood in light of the strategic report's statutory purpose, namely to inform members of the company and to help them assess how the directors have performed their duty to promote the success of the Company under section 172 of the Act.

(viii) The communication principles suggest that strategic reports should have the following characteristics – be fair, balanced and understandable; be concise; have forward-looking orientation; include entity-specific information; and link-related information in different parts of the annual report. They are intended to emphasise that the strategic report is a medium of communication between a company's directors and its shareholders.

(ix) The content elements for the strategic report set out in the [draft] guidance are derived from the Companies Act 2006, as amended by the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013, and include a description of the entity's objectives, strategies and business model. In addition, the strategic report should include an explanation of the main trends and factors affecting the entity; a description of its principal risks and uncertainties; an analysis using key performance indicators; and an analysis of the development and performance of the business. The entity's performance in relation to ~~Disclosures around~~ the environment, employees, social issues, community issues, and human rights issues ~~and diversity are also~~ is required to be disclosed to the extent necessary for an understanding of the development, performance or position of the entity's business.~~incorporated~~.

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Section 1
Objectives and how to use this Guidance

1.1 The objectives of this [draft] Guidance on the Strategic Report are to:

(a) ensure that relevant information that meets the needs of shareholders is presented in the strategic report;

<u>(b) ensure that strategic reports include the information necessary to enable them to fulfil their statutory purpose;</u>

(<u>c</u>~~b~~) encourage companies to experiment and be innovative in the drafting of their annual reports, presenting narrative information in a way that enables them to best 'tell their story' while remaining within the regulatory framework; and

(<u>d</u>~~c~~) promote greater cohesiveness in the annual report through improved linkage between information within the strategic report and in the rest of the annual report.

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Section 4
The narrative reports

4.1 The narrative reports comprise the strategic report and the directors' report. The objectives of the narrative reports are:

- to provide information on the entity and insight into its main objectives and strategies, and the principal risks it faces;

<u>- in the case of the strategic review, to provide information sufficient to enable shareholders to assess how the directors have performed their duty to promote the success of the entity under section 172 of the Act,</u> and

- to complement, supplement and provide context for the related financial statements.

4.2 Information in the narrative reports should complement as well as supplement the financial statements.

4.3 In complementing the financial statements, the narrative reports should provide information about the business and its development, performance or position that is not reported in the financial statements but which might be relevant to the shareholders' evaluation of past results and assessment of future prospects.

4.4 In supplementing the financial statements, the narrative reports should provide additional explanations of amounts recognised in the financial statements and explain the conditions and events that shaped the information contained in the financial statements.

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Section 5
Strategic reports and materiality

5.1 Information is material if it is necessary for an assessment by shareholders as to how the directors have performed their duty to promote the success of the entity under section 172 of the Act.

Information is material if its omission from or misrepresentation in the strategic report might reasonably be expected to influence the economic decisions shareholders make on the basis of the annual report as a whole. Such information should be included in the strategic report.

Conversely, the inclusion of immaterial information can obscure key messages and impair the understandability of information provided in the strategic report. Immaterial information should be excluded from the strategic report.

5.2 The strategic report should contain ~~only~~all the information that is relevant to shareholders' needs and which is necessary to enable the strategic report to fulfil its statutory purpose. However, t~~T~~he inclusion of too much information or detail may obscure matters of importance and will not promote a clear understanding of the entity's development, performance, position and future prospects.

[and insert the following 'Example" and "linkage Example" after section 5.6]

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Example

Information relating to the extent to which and the manner in which the parent company establishes policies for and monitors management and minimisation of group risks, such as social, environmental, community and human rights risks associated with the operations or activities of subsidiary undertakings are likely to be strategically significant and therefore should be included in the strategic report.

Linkage example

The description of the manner in which a parent company manages group risks could cross refer to other relevant material in the strategic report relating to risks and uncertainties generally and the entity's approach to relevant social, environmental, community and human rights issues.

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Section 6
The strategic report

6.2 The strategic report has four~~three~~ main content-related objectives:

(a) to provide context for the related financial statements;

(b) to provide shareholders with an analysis of the entity's past performance; ~~and~~

(c) to provide insight into the entity's main objectives and strategies, and the principal risks it faces and how they might affect future prospects; and

(d) to provide shareholders with insight into the manner in which the directors have performed their duty under section 172 of the Act to promote the success of the company for their collective benefit.

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[Insert a new section 6.7A as follows]

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6.7A As far as possible there should be consistency in the selection, evaluation, compilation and presentation of information to enable shareholders to analyse the performance of the entity over time.

Example

Information regarding the settlement of a material legal claim against an entity may not be considered 'strategically significant' information. It may, however be relevant to an assessment of how the directors have performed their duty under section 172 of the Act to promote the success of the company for the collective benefit of members. It is, ~~however~~in any case, important contextual information relating to the period under review which should be included in the strategic report.

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6.15 The strategic report should also be comprehensive. This does not mean that it should cover all possible matters in substantial detail; the strategic report should include only focused information, which is important to the entity when taken as a whole and is relevant to shareholders' needs in light of the strategic report's statutory purpose (see section 6.1 to 6.4 above).

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6.34 While some objectives may be defined in terms of financial performance, non-financial objectives including ESG objectives should also be disclosed where achieving them is important for the entity's future development, performance and position.

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p. 22 (trends and factors)

6.42	To the extent necessary for an understanding of the development, performance or position of the entity's business, the strategic report should include the main trends and factors likely to affect the future development, performance or position of the business.

6.43 Trends and factors affecting the business may arise either as a result of the external environment in which the entity operates or from internal sources.

> *Linkage example*
>
> The reasons for the entity adopting its principal objectives and strategies (and the business model) may be clarified through a linkage to a description of trends and factors affecting an entity.

6.44 The development, performance and position of every entity is affected by its external environment. The strategic report should include a description of the entity's major markets and its competitive position within those markets. It should cover the significant features of the legal, regulatory, macro-economic and social environment in which the entity operates, and how that has influenced the business. It should also set out the directors' analysis of the potential effect on the future development, performance or position of the entity of the trends or factors identified. It should describe how directors have taken account of the factors identified in section 172 of the Act in their decision-making.

> *Example*
>
> Changes in a regulatory environment can create opportunities as well as risks. For instance, directors may have recognised that changes in environmental laws have the potential to create new markets for an entity. Where this is the case, the implications of the legal regulatory changes should be explained in the strategic report and linked to any information elsewhere in the report on social and environmental factors.

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> *Linkage example*
>
> The strategic report will require a discussion of the economic outlook and its implications for the entity's future prospects and performance, with linkages to a discussion of how the company will approach staffing and employment issues in light of these forecasts.

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6.45 Where practicable and relevant, the trend or factor should be quantified and the source of the evidence underpinning it identified.

Example

An entity may wish to state in its strategic report that the market in which it operates has grown substantially in the past five years. In this case, the strategic report should, where practicable, indicate by how much the market has grown and provide a link to the research or report from which the statistic has been taken.

6.46 The strategic report should discuss internal trends and factors likely to affect the future development, performance or position of the entity. These will vary according to the nature of the business, but could, for example, include the development of new products and services or the benefits expected from capital investment.

6.47 Directors should consider the potential future significance of trends or factors in deciding whether or not to include an analysis of them in the strategic report.

Example

The social environment within which an entity operates can change quickly, for instance as a result of a specific incident or media exposure. The incident or exposure need not relate specifically to the reporting entity for it to be relevant to shareholders. It this is indicative of a possible change or development in social environment with potential to alter the entity's future development, performance and position (or has the potential to precipitate one) then it is material to shareholders and should be discussed in the strategic report.

6.48 Given the influence trends and factors might have on many aspects of the entity's development, performance or position, the linkage of this type of information to other areas of the strategic report and the annual report more widely will be particularly important.

Linkage example

The strategic report might highlight any principal risks or opportunities that arise from, and strategies that have been adopted as a result of, the significant trend or factor identified.

Linkage example

The discussion of trends and factors in the strategic report will need to highlight the links to the discussions on environmental, employee, community, and human rights issues that appear elsewhere in the report.

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p. 23-24 (risks and uncertainties)

6.49

> The strategic report should include a description of the principal risks and uncertainties facing the entity, together with an explanation of how they are managed or mitigated.

6.50 The risks and uncertainties included in the strategic report should be limited to those considered by the entity's management to be the most important to the future development, performance or position of the entity. They will generally be matters that the directors regularly monitor and discuss because of their likelihood, or the magnitude of their potential effect on the entity~~,~~ (or a combination of the two) in the long term as well as the short term. To enable the strategic report to fulfil its statutory purpose, the discussion of risks and uncertainties will demonstrate to shareholders the extent to which and the manner in which the directors have taken account of the factors identified in section 172(1) of the Act.

6.51 Principal risks or uncertainties with potential effects of such a magnitude that they may threaten the entity's viability (ie its solvency and/or liquidity) should be explained fully and given due prominence.

6.52 Directors should consider the full range of business risks including commercial, operational, ~~and~~ financial, economic, social, environmental, human rights and reputational risks. Principal risks should be disclosed and described irrespective of how they are classified or whether they result from strategic decisions, operations, organisation or behaviour, or from external factors over which the board may have little or no direct control.

6.52A The strategic report will describe the methods that are used within the entity to identify and evaluate various sources of risk. The strategic report will provide an insight into how the factors listed in section 172 of the Act are taken account of in risk management processes.

6.53 The descriptions of the principal risks and uncertainties facing the entity should be sufficiently specific that a shareholder can understand why they are important to the entity. This might include a description of the likelihood of the risk, an indication of when the risk might be most relevant to the entity and its possible effects. Significant changes in principal risks such as a change in likelihood or possible effect, or the inclusion of new risks, should be highlighted and explained. An explanation of how the principal risks and uncertainties are managed or mitigated should also be included.

> *Example*
>
> It could be useful to explain the change in risk profile since the previous year and how the entity has responded to this change in terms of its risk mitigation.

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Linkage example

The disclosure of the reporting and monitoring process for each risk, explaining the entity's risk appetite, how often the risk is reviewed, and by whom, could enhance linkage to information in the corporate governance report (eg the internal control statement or the audit committee report).

6.54 A risk or uncertainty may be unique to the entity, a matter that is relevant to the market in which it operates, or something that applies to the business environment more generally. Where the risk or uncertainty is more generic, the description should make clear how it might affect the entity specifically.

Linkage example

Where relevant, the description of the principal risks and uncertainties facing the entity should include linkage to and discussion of the entity's strategies, business model and key performance indicators. Any linkage to accounting estimates and judgements disclosed in the notes to the financial statements, trends or factors from the external environment described elsewhere in the strategic report, or any other linked disclosure in the annual report (e.g. environmental, employee, social, community or human rights factors), could also be highlighted and, where relevant, discussed.

6.55 The analysis in the strategic report should include the financial and non-financial key performance indicators (KPIs) utilised by the directors to measure progress towards achieving a particular objective or strategy.

6.56 The KPIs used in the analysis should be those that the directors judge are most effective in assessing progress against objectives or strategies. Where possible, they should be accepted and widely used, either within the entity's industry sector or more generally. Where possible, KPIs should be quantitative (as opposed to qualitative) so that shareholders are in a position to assess whether the information is objectively supportable.

Linkage example

The use of KPIs in relation to an entity's strategies will clearly show the progress an entity has made towards achieving its objectives or strategies.

Linkage example

The use of KPIs in relation to an entity's strategies will clearly show the progress an entity has made towards the proper management of various business risks, including environmental, employee, social, community and human rights risks.

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Linkage example

Highlighting those KPIs which form part of directors' incentive plans, along with links to principal risks, provides an overview of how the performance of the business is related to executive remuneration.

6.57 Comparatives should be included for KPIs and the reasons for any significant changes from year to year explained. Where available, the corresponding data and values for the previous year should be shown to enable shareholders to evaluate the entity's performance over time.

6.58 The entity should provide information that enables shareholders to understand each KPI used in the strategic report. For example, the following information should be identified and explained where relevant:

(a) its definition and calculation method;

(b) its purpose;

(c) the source of underlying data;

(d) any significant assumptions made; and

(e) any changes in the calculation method used compared to previous financial years,

including significant changes in the underlying accounting policies adopted in the financial statements which might affect the KPI.

6.59 Where a line-item from the financial statements, or a commonly used KPI, or a KPI used in another report (e.g. a sustainability report) has been adjusted for inclusion in the strategic report, the term used for that adjusted measure should be clear and, where practicable, a reconciliation to an appropriate financial statement line-item and explanation of any adjustments should be provided.

Example

Where an entity uses earnings before interest, tax, depreciation, amortisation (EBITDA) and certain restructuring costs as a KPI, the measure could be referred to as 'Adjusted EBITDA' or similar and a reconciliation to an appropriate financial statement line-item and explanation of the adjustment provided.

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6.63 The strategic report should set out the key strengths and tangible and intangible resources available to the entity, which will assist it in the pursuit of its objectives. Particular attention should be given to those items that are not reflected in the financial statements. Depending on the nature of the business, these may include: corporate reputation and brand strength; ~~-~~ natural resources; environmental performance, employees; research and development; social and philanthropic initiatives, community impacts, human rights impacts, intellectual capital; licences, patents, copyrights and trademarks; and market position.

p. 26-27 (environmental, social, community and human rights factors)

6.64

> To the extent necessary for an understanding of the development, performance or position of the entity's business, the strategic report should include information about:
>
> (a) environmental matters (including the impact of the business of the entity on the environment);
>
> (b) the entity's employees; and
>
> (c) social, community and human rights issues.

6.65 There ~~may~~ will usually be a strong relationship between the development, performance, position or future prospects of an entity and the matters described in paragraph 6.64, particularly over the longer term. The strategic report should include information on these matters when their influence, or potential influence, on the development, performance, position or future prospects of the entity's business is of such a nature or magnitude that they are relevant to shareholders and their ability to determine how directors are performing their duty to promote the success of the company for the collective benefit of members under section 172 of the Act (see paragraph 6.4). The strategic report should not, however, be seen as a replacement for other forms of reporting addressed to other stakeholders.

> *Linkage example*
>
> The way an entity conducts its business in relation to the issues in paragraph 6.64 may affect its licence to operate/trade in a particular location or market, or result in a major event that will directly or indirectly affect the entity (eg a material litigation, loss of revenue or reparation cost) or result in a loss of a market or revenue, e.g. as a result of a consumer boycott. The risk of such an event may constitute a principal risk or uncertainty to the entity.

> *Linkage example*
>
> The identification of the key inputs and outputs of the business, together with the key stakeholder relationships could be linked to the business model and strategies to help explain the reasons why each particular matter or issue is important to the business.

6.66 Where this information is material (see paragraph 5.1) it should be placed in the strategic report. If the directors consider that this type of information is important but not material to shareholders, the information could be located elsewhere, for example, in a sustainability report.

Linkage example

The strategic report should clearly highlight and cross-refer to any additional or supplemental material or evidence that appears in any other report (e.g. a sustainability report or disclosures under another other industry-specific or general corporate transparency initiative). As far as possible, the methods of gathering, evaluating compiling and presenting material for the strategic report (including the use of KPIs) should reflect that used in other reports (e.g. sustainability reports).

6.67 Where a discussion of an issue related to any of the matters described in paragraph 6.64 is considered necessary for an understanding of the development, performance, position or future prospects of the entity's business, the strategic report should make clear why it is considered necessary. It should also include information on the policies of the entity on those matters and the effectiveness of those policies. Where possible, KPIs should be used to demonstrate the effectiveness of those policies (see paragraph 6.55 to 6.59).

Linkage example

In order to fulfil their duty to promote the success of the company, the directors may have put in place human rights due diligence processes to identify and evaluate possible areas of human rights risk. Where the nature or magnitude of possible human rights risks are such that they would be material to shareholders (see paragraph 5.1), they must be disclosed in the strategic report along with a discussion of the action that has been taken in response. The strategic report should highlight the relevant links to the discussion on principal risks and uncertainties that appear elsewhere in the report.

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Example

An entity that sources its products from overseas could face risks relating to stakeholder (eg customer) concerns relating to local labour practices. In this situation, the entity might have put in place a system to validate and monitor supply chain performance, specifically related to adherence to stated policies. The directors might also monitor the effectiveness of those policies with KPIs. Where the nature or magnitude of the potential effect of the risk on the business is such that it would ~~be of interest~~material to shareholders (see paragraph 5.1), it ~~should~~must be described and discussed in the strategic report, together with information about, and an analysis of, the relevant KPIs used by the directors to track the entity's performance and progress .~~.~~

Example

A parent company with a subsidiary undertaking operating in an area of political instability could face risks resulting from the activities of that subsidiary undertaking, or its business relationships. In this case, the parent company might have put in place a system to monitor the social, environmental or human rights performance of the subsidiary. The directors may monitor the performance of that subsidiary undertaking with the use of KPIs, or through feedback from stakeholder groups or through complaints mechanisms. Where the nature of magnitude of the potential risks on the business is such that it would be material to shareholders (see paragraph 5.1), those risks, together with details of the action taken in response, must be disclosed in the strategic report. In addition, the strategic report should include information about, and a discussion of, the relevant KPIs and other information used to track performance.

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