

Section 172(1)
reporting: Emerging
observations
from December
2019 reporters

April 2020



Building a better
working world

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Introduction

Under the Companies (Miscellaneous Reporting) Regulations 2018 (MRR) for the first time certain companies now include a separately identifiable section 172(1) statement in their December 2019 Annual Report and Accounts (ARA). This statement explains how directors had regard to the matters set out in Section 172(1)(a)-(f) of the Companies Act 2006¹.

Companies are currently facing unprecedented challenges in light of COVID-19. Many boards are having to make difficult decisions that are critical to the survival and viability of their companies. These decisions are likely to have far-reaching implications for their stakeholders. How directors consider and exercise their Section 172 (s172) duties in these challenging times will be paramount. We therefore expect reporters with year-ends on, or after, February 2020 to use this new disclosure requirement as a platform to explain the choices made by directors. After all, the very intention of introducing the requirement was to encourage businesses to take the right long-term decisions and help restore the public's trust by giving a stronger voice to those outside the boardroom.²

To help companies respond to this challenge, EY's Corporate Governance team has reviewed over 60 published ARAs of 31 December 2019 FTSE 350 reporters³ and has summarised our early/emerging observations on these statements. Given this is the first year of reporting on s172, it would be premature to talk about good or best practice. But we hope that, for companies who are still to report (including private companies and subsidiaries of groups), our observations are useful.

¹ For premium listed companies, in addition to the requirements in MRR, the 2018 UK Corporate Governance Code (Provision 5) requires the board to "understand the views of the company's other key stakeholders and describe in the annual report how their interests and the matters set out in section 172 of the Companies Act 2006 have been considered in board discussions and decision-making."

² *Corporate Governance: The Government response to the green paper consultation*, August 2017.

³ EY's Corporate Governance team has reviewed over 60 published ARAs.

1

Overall findings

“

Reporting must cover the concerns raised by stakeholders, how companies have understood the issues, and how they have thought carefully about how these impact on the long-term success of the company.”

FRC, Annual Review of the UK Corporate Governance Code, January 2020

Not surprisingly, given the very high-level nature of the new requirement, the approach reporters have taken is quite varied.

1

All of the companies we reviewed referred to **stakeholder engagement**, either directly within their section 172(1) statement, or cross referred to such a disclosure elsewhere.

2

To explain how directors “**have had regard to section 172 (1)(a)-(f)**”, more than two-thirds (69%) of the companies discuss the impact on decisions made – either by including case studies of a few decisions; listing all principal decisions in the year; or providing a narrative setting out how, in general, board decisions considered stakeholders.

3

Where companies did not refer to decision making, a more common approach was to describe the general governance processes in place. For example, by making reference to bullets (a) through (f) of section 172(1).

4

Only a few companies covered other s172 factors beyond stakeholder engagement e.g., the long-term consequences of decisions and the impact of decisions on their reputation and standing.

5

Section 172 is a director’s duty, but the disclosures do not always differentiate clearly between what was done by the directors versus by management.

“

Investors are keen to better understand how directors are fulfilling their duties and taking account of the views of the company’s material stakeholders ... From our engagement with companies, it is clear that the full breadth of stakeholder engagement companies undertake is not always included in a company’s annual report. Investors and other interested parties cannot truly appreciate these efforts unless company’s adequately disclose their engagements and the impact those engagements have had on board decision making.”

The Investment Association, Shareholder Priorities For 2020 – Supporting Long Term Value in UK Listed Companies, January 2020

Engaging stakeholders

On average, companies referred to seven key stakeholders, with a minimum of three and a maximum of 13. Companies in the health and energy sector had the highest number of stakeholders while investment trusts had the fewest.

Apart from some investment trusts, all companies included employees, people or colleagues as a key stakeholder group. Often these terms were not defined. So it was unclear whether, for example, the engagement mechanisms applied to all 'people' or just to 'employees' and not to contractors or contingent workers. Interestingly, fewer companies than we expected used the term 'workforce'⁴. **Lloyds Banking Group** 2019 ARA (p.22) provides a definition of workforce directly within its section 172(1) statement which includes, among other groups, contingent workers.

Customers were the next most common stakeholder group. Sometimes, references included 'customers and clients' or 'customers and users' but the terms used were not distinguished e.g., how customers are different from 'users' and 'clients'. We recommended in our *'Deconstructing the section 172(1) statement'* publication that there is benefit in providing a clear definition of each key stakeholder group.

Many companies referred to communities and the environment as key stakeholders and some also separately considered society. Other common stakeholders include investors and shareholders, regulators and the government, as well as suppliers and (strategic) partners. There were some sector nuances too when it came to stakeholder groups. For example, companies in the hotel and leisure sector considered hotel owners, building societies considered their members, insurers considered their brokers, and investment trusts considered investment managers and investee companies. A surprisingly small number of companies considered debt holders (e.g. **Indivior** 2019 ARA (p.20) or pensioners (e.g. **Royal Dutch Shell** plc 2019 ARA (p.24)) to be a key stakeholder.

On average, companies referred to seven key stakeholders, with a minimum of three and a maximum of 13.

Stakeholder narratives tended to refer to the strategic/key issues and topics relevant to the company, the methods of engagement and outcomes or future actions. Some companies included other helpful disclosures such as:

- ▶ Reporting that a stakeholder review/mapping exercise was undertaken in the year to ensure key stakeholders had been identified and engagement mechanisms remained appropriate e.g., agreeing which stakeholders the board needed to engage with directly versus those for which information from management could be relied on (**Rentokil Initial** plc 2019 ARA (p.22) and **Croda International** plc 2019 ARA (p.54)).
- ▶ The reasons why engagement with a group is important or beneficial (**Allianz Technology Trust** plc 2019 ARA (p.62)).
- ▶ What stakeholders told the business (**Barclays** plc 2019 ARA (pp.16-17)) or what they have learnt from the engagement (**Coats** plc 2019 ARA (pp.20-23)).

- ▶ The company's response when things go wrong (**HSBC Holdings** plc 2019 ARA (pp.16-19)).
- ▶ Their measure of the success of the engagement (**William Hill** plc 2019 ARA (pp.22-23) and **Rentokil Initial** plc 2019 ARA (pp.22-23)).
- ▶ Context for the stakeholder engagement by reference to the strategic pillars and principal risks (**British American Tobacco** plc 2019 ARA, pp.26-27).

We did not identify many companies that included stakeholder metrics as part of their disclosure. Some exceptions included:

- ▶ **BP** plc 2019 ARA (p.67), **Croda International** plc 2019 ARA (pp.14-15), **Fresnillo** plc 2019 ARA (pp.18-19) and **Taylor Wimpey** plc 2019 ARA (p.33) disclosed measures of value or impact for each key stakeholder e.g., total dividends paid (shareholders); turnover rate (employees and unions); amount paid in income and production taxes (government and regulators); and amount invested in research and development (partners and suppliers).
- ▶ **HSBC Holdings** plc 2019 ARA (pp.15 and 42) disclosed environmental, social and governance (ESG) targets and metrics on sustainable finance and investment, customer satisfaction, employee advocacy etc.

Stakeholder narratives tended to refer to the strategic/key issues and topics relevant to the company, the methods of engagement and outcomes or future actions.

⁴ While the MRR makes reference to 'employees', the 2018 Code uses the term 'workforce'. The FRC's Guidance on Board Effectiveness (see paragraph 47-60) and its Guidance on the Strategic Report (see paragraph 7B.46) encourage companies to consider the international workforce (not just UK employees) and those under different forms of working arrangements other than permanent employment contracts.

3 “Having regard”

The narrative on how directors “had regard to the s172(1) (a) to (f)” factors is more varied, although references to principal decisions (sometimes referred to as key or major too) appear to be the most common approach.

A number of companies, for example **Royal Bank of Scotland plc** 2019 ARA (p.48), provided a definition of what constitutes a principal decision. The definitions are broadly similar i.e., those decisions taken by the board that are material/of strategic importance to the firm, key stakeholders, and/or the long-term value creation of the company. A few companies, like **AstraZeneca plc** 2019 ARA (p.106), broadened the definition to include “board discussions” as this is referenced in the 2018 Corporate Governance Code. For each of its principal decisions, **Lloyds Banking Group plc** 2019 ARA (p.22) provides a link to its strategic priorities.

Where companies listed principal decisions, on average they referred to between three and four, with one company disclosing as many as nine. Common decisions were:

- ▶ Capital allocation decisions such as:
 - Capital distributions including share buy backs (**F&C Investment Trust plc** 2019 ARA (p.18)).
 - Changes in dividend policy (**The Law Debenture Corporation plc** 2019 ARA (p.37)).
 - Dividend payments (**Persimmon plc** 2019 ARA (p.70)).

The narrative on how directors “had regard to the s172(1) (a) to (f)” factors is more varied, although references to principal decisions (sometimes referred to as key or major too) appear to be the most common approach.

- Major investments/material corporate activity including acquisitions (e.g. **London Stock Exchange Group** 2019 ARA (p.51)).
- ▶ Large-scale restructuring (e.g. demerging of the Wickes business from **Travis Perkins plc** 2019 ARA (p.68)).
- ▶ Collaboration with partners (**AstraZeneca plc** 2019 ARA (p.106) and **Aggreko plc** 2019 ARA (p.43)).
- ▶ Board appointments (e.g., appointment of two employees to the board (**Capita plc** 2019 ARA (p.39)).
- ▶ Changes to governance structures (e.g., disbanding the pensions committee following review (**Coats Group plc** 2019 ARA (p.24)).

We did not identify many examples of decisions with negative/adverse consequences for impacted stakeholder groups.

- ▶ Remuneration policy changes (**GlaxoSmithKline plc** 2019 ARA (p.88)).
- ▶ New/refreshed corporate purpose (**HgCapital Trust plc** 2019 ARA (p.22) on considering purpose, culture and values).
- ▶ Approval of the strategic business plan and budget (**Evrax plc** 2019 ARA, p.113).
- ▶ ESG strategy (**British American Tobacco plc** 2019 ARA (pp.74-75) on environmental targets and climate change reporting, and **GlaxoSmithKline plc** 2019 ARA (p.87) on ESG insights).

The amount of detail provided around principal decisions varied, ranging from a high-level summary to a very detailed analysis of the board’s considerations. An example of the former is **Standard Chartered plc** 2019 ARA (p.46) which detailed the sale of its joint venture investment in an Indonesian bank and succinctly referenced the key stakeholders that were impacted; and an example of the latter is **Pearson plc**’s explanation of its decision to acquire Lumerit Education which included detail on the board’s consideration of impact on individual stakeholder groups such as learners, shareholders and educational institutions (2019 ARA, p.61).

Interestingly, a few companies also disclosed decisions not to do something or to reverse previous decisions. **Barclays plc** 2019 ARA (p.17) discussed reversing its decision to withdraw over the counter access to cash for customers at post offices in the UK and **HSBC Holdings plc** 2019 ARA (pp.42-43) explained its decision not to enhance the pension benefits for a certain group of members.

We did not identify many examples of decisions with negative/adverse consequences for impacted stakeholder groups. Some exceptions included **William Hill plc** 2019 ARA (pp.73-74 – decision to close 713 shops) and **Moneysupermarket.com Group plc** 2019 ARA (p.72 – relocation of employees to a new office) which explained

the employee engagement activities that were undertaken as part of the decision-making process. Given the current challenging circumstances in which companies are operating in under COVID-19, we expect this to change in the ARAs of reporters with years ends on or after February 2020.

Some companies chose not to focus on principal decisions but instead provided more information on the outcomes of stakeholder engagement – sometimes applying a stakeholder impact analysis lens. As an example, **Legal & General Group plc** 2019 ARA (pp.62-63) identified the risks, benefits and mitigating actions for employees, customers, suppliers and regulators in relation to its decision to sell the general insurance business.

When this approach is taken, it might not be immediately clear whether the outcomes that are discussed are current year outcomes or actions for the future. To avoid this ambiguity, **Smith+Nephew plc** 2019 ARA (pp.84-85) uses clear headings on future (2020) actions for stakeholder engagement. Other companies have taken the approach of providing a broader narrative, explaining how the board has regard for stakeholders in decision making, with a focus on the underlying processes. For example, **BP plc** 2019 ARA (p.67) explains its delegation of authority framework and the procedures in place to support the board’s consideration of stakeholders in decision-making by reference to the board’s monitoring of BP’s organisational structure, workforce engagement, culture etc.

Some companies, such as **Centrica plc** 2019 ARA (p.66), illustrate which stakeholder groups were considered for each key area of board discussion such as strategy and business plan, as well as performance and risk. This is different, in that the stakeholder narrative is by area of board activity, rather than by decision.

4

Beyond stakeholders



Broader consideration of other section 172 factors

We found fewer examples of companies addressing other broader s172 factors, such as the long-term consequences of decisions and their impact on a company's reputation and standing.

Lloyds Banking Group plc 2019 ARA (p.22-23), **Aggreko plc** 2019 ARA (pp.42-32), **Fresnillo plc** 2019 ARA (pp.104-105) and **Bupa** 2019 ARA (p.26) disclosed the long-term implications under a clear heading for each principal/key board decision e.g., by reference to the company's strategy, risk management and business model.

ITV plc 2019 ARA (p.63) explained the board's consideration of the long term with reference to the company's refreshed purpose and strategy, as well as the setting of the dividend policy.

Tullow Oil plc 2019 ARA (p.7) explained that its reputation and the trust of investors was a key consideration by the board in reaching some challenging decisions e.g., to suspend the dividend.

5 Director's duty, not management's



Section 172 is a director's duty, rather than management's and, in some cases, it was difficult to determine how the directors had discharged it.

This was particularly where:

- ▶ Cross-references were too broad and ambiguous e.g., to the entire sustainability section within an ARA which largely detailed management's engagement.
- ▶ A passive voice was used to describe the engagement activities.
- ▶ The disclosure referred to 'we' rather than being specific about who within the company undertook the engagement.

It is important that new disclosures are not 'bolted-on' to existing narrative, but thoughtfully integrated to avoid repetition and retain narrative flow. Cross-referencing can be a useful means to achieve this, but equally, clarity and specificity are required.

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Adding clarity using headings such as 'Board engagement' is helpful. **Lloyds Banking Group plc's** 2019 ARA (pp.20-27 and pp.32-37) differentiates between the board's direct and indirect engagement for each key stakeholder group. **Rentokil Initial plc** 2019 ARA (pp.76-77) sets out the information flow to the board and direct board engagement for each stakeholder group.

Interestingly, some companies also used an index or a content roadmap for the section 172(1) statement – similar in nature to an index used by some to present their Non-Financial Reporting Directive (NFRD) disclosures. **Centrica plc** 2019 ARA (p.57) includes such an index. **Taylor Wimpey plc** 2019 ARA (pp.32-33) integrated the narrative within its sustainability reporting and included icons to enhance linkages.

If you are still to report ...

For companies (including subsidiaries) that are yet to report, we encourage you to refer to our earlier publication '[Deconstructing the section 172\(1\) statement](#)'. From the feedback we received from the December 2019 reporters, it provides a useful approach by which to frame the disclosures.

As a first step, if you haven't already done so, undertaking a careful assessment of which group entities are in the scope of the legislation is important, particularly given the detailed nuances in the legislation. For example:

- ▶ The "balance sheet total" threshold is a total assets threshold, not net assets.
- ▶ For a holding company, it is important to consider the size of the group that it heads⁵
- ▶ There are complexities created by the ineligibility criteria. Certain companies may be ineligible in their own right; and some group companies may be members of an ineligible group. In both cases, these are caught by the new disclosure requirement⁶:

- a. Small companies are in scope if they are ineligible in their own right (e.g., authorised insurance companies and banking companies)⁷.
- b. Medium sized companies are in scope if they are ineligible in their own right or are a member of an ineligible group⁸.

Once a detailed scoping assessment is complete, bear in mind the following as you begin drafting your disclosures:

- ▶ Ensure that your statement is clear about how directors discharged their duty as s172 is a directors' duty. For example, state how directors were involved in engagement with key stakeholders rather than how management was involved.
- ▶ Write in an active voice to avoid boiler plate disclosure. For example, your disclosure should make clear:
 - Who undertook the engagement activities.
 - The specific nature of the engagement in the current year (rather than in general) and the feedback obtained.

⁵ Sections 465 and Section 466 Companies Act 2006.

⁶ Sections 384 and 467 Companies Act 2006. We recommend seeking legal advice in complex situations. Note that the list of excluded companies changes for financial years beginning on or after 31 December 2020.

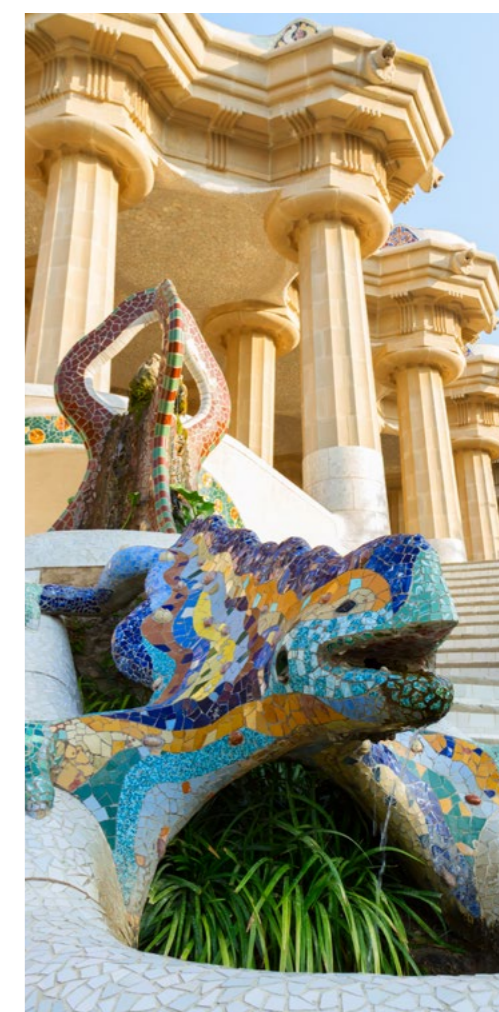
⁷ Section 414B. Companies taking advantage of the small companies exemption not to prepare a strategic report need not prepare a s172 statement. A small company that is a member of an ineligible group but is not an ineligible company itself need not give a s172 statement.

⁸ To note:

- ▶ An entity listed on the Main Market (which is a regulated market) is itself ineligible and the group that it is part of is an ineligible group
- ▶ An AIM company is itself ineligible (because it will be a plc), but the group that it is part of is not an ineligible group (because AIM is not a Regulated Market).

- The principal decisions made in the year rather than annually recurring governance processes.
- ▶ Consider explaining the terms you use in simple English as company specific terminology e.g., for certain stakeholder groups or engagement mechanisms, may not be meaningful. Readers may infer different meanings from terms like 'colleagues' 'community' or 'employee panels'.
- ▶ Demonstrate how directors had regard for matters in s172 by reporting on stakeholder impacts and outcomes or by detailing how stakeholder input influenced principal decisions.
- ▶ Consider separately highlighting those aspects of engagement that were undertaken in response to the COVID-19 situation – companies can use the statement to set out how the board kept the adequacy of stakeholder engagement mechanisms under review in this period.⁹
- ▶ Explain how directors considered the broader factors in s172, such as the long-term consequences of decisions and the reputation and standards of business conduct, when making decisions.
- ▶ When discussing principal decisions taken in response to COVID-19, it will be very important to explain the board's consideration of the impact on the business reputation and company culture.
- ▶ In relation to disclosures by subsidiaries of groups:
 - Governance and compliance processes – and often decision making – do not operate along legal entity lines, yet the MRR disclosures do. The earlier groups of companies can think about this misalignment, the more considered their approach and the resulting disclosures will be.
 - It is likely that the disclosures may need to be tailored by subsidiary, or at least some thought given to identify if, for a sub-set of the subsidiaries, tailoring is needed as the principal decisions are likely to vary by entity. For example, if there is a subsidiary which is the primary external customer facing entity in the group, the disclosures with respect to customer engagement, and how this has been regarded by the directors including in making principal decisions, is likely to have much more relevance than for a subsidiary which is just the primary employing entity for all the employees in the group.

The interest in these disclosures is only likely to grow. For example, the recently published Brydon Report recommends that the audit report includes a statement on "whether the directors' s172 statement is based on observed reality on the basis of the auditor's knowledge of the company and its processes". Companies must bear in mind the political and regulatory context of why these requirements were introduced and demonstrate how they are grasping their spirit and holding themselves to account. Failure to do this risks the imposition of further regulation as governments look for further ways to restore public trust in business and the capital markets. A far better course is for companies to strive now to achieve good standards of corporate governance and reporting, using the ARA as the high-quality communication channel it can be.



⁹ The 2018 UK Corporate Governance Code (Provision 5) states that the board should keep engagement mechanisms under review so that they remain effective.

For support and further information, please contact us

EY's UK Corporate Governance team produces thought leadership on governance and reporting matters based on our own research as well as engagement with investors, boards and regulators. We also provide practical advice and guidance to management and boards to improve their governance practices and narrative reporting.

We will continue to monitor section 172(1) statements as more ARAs are published. This enables us to provide guidance and benchmark on your section 172(1) statement against developing market practice and requirements. Contact us to discuss in more detail how we can help you achieve best in class reporting.

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