

### 3 AUDITOR REPORTING ON STRATEGIC REPORTS

#### (LECTURE A608 – 22.13 MINUTES)

For periods commencing 1 January 2016, SI 2015/980 has extended auditors responsibilities to report on the directors' report and the strategic report.

Where companies early adopted the new accounting regime (for periods commencing 1 January 2015), auditors were also expected to adopt the new auditor reporting requirements. Early adoption was usually done to take advantage of the new increased small company thresholds or to adapt the financial statements for a medium- sized or large company.

#### 3.1 *Reporting*

The new requirements in the auditor's report relate to reporting on whether the strategic report and the directors' report have been prepared in accordance with applicable legal requirements and whether they contain and material misstatements.

The new wording in the auditor's report is as follows, for a company that produces a strategic report:

##### **Opinions on other matters prescribed by the Companies Act 2006**

In our opinion, based on the work undertaken in the course of the audit:

- the information given in the strategic report and the directors' report for the financial year for which the financial statements are prepared is consistent with the financial statements; and
- the strategic report and the directors' report has been prepared in accordance with applicable legal requirements.

##### **Matters on which we are required to report by exception**

In the light of the knowledge and understanding of the company and its environment obtained in the course of the audit, we have not identified material misstatements in the strategic report or the directors' report.

#### 3.2 *So what?*

The big issue is that the responsibility to report that the ***strategic report is prepared in accordance with applicable legal requirements*** is not just a new element in the report, it is also a new responsibility.

It is an onerous responsibility too. Many strategic reports are half-hearted at best and some are worse than that.

The core issue is: what is compliant and what is not?

### **3.3    *The applicable legal requirements – s414c***

The Companies Act 2006 contains the following requirements for the content of the strategic report:

#### **414C    Contents of strategic report**

(1) The purpose of the strategic report 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).

(2) The strategic report must contain—

- (a) a fair review of the company's business, and
- (b) a description of the principal risks and uncertainties facing the company.

(3) The review required is a balanced and comprehensive analysis of—

- (a) the development and performance of the company's business during the financial year, and
- (b) the position of the company's business at the end of that year,

consistent with the size and complexity of the business.

(4) The review must, to the extent necessary for an understanding of the development, performance or position of the company's business, include—

- (a) analysis using financial key performance indicators, and
- (b) where appropriate, analysis using other key performance indicators, including information relating to environmental matters and employee matters.

(5) In subsection (4), "key performance indicators" means factors by reference to which the development, performance or position of the company's business can be measured effectively.

(6) Where a company qualifies as medium-sized in relation to a financial year (see sections 465 to 467), the review for the year need not comply with the requirements of subsection (4) so far as they relate to non-financial information.

(7) In the case of a quoted company the strategic report must, to the extent necessary for an understanding of the development, performance or position of the company's business, include—

- (a) the main trends and factors likely to affect the future development, performance and position of the company's business, and

(b) information about—

- (i) environmental matters (including the impact of the company's business on the environment),
- (ii) the company's employees, and
- (iii) social, community and human rights issues,

including information about any policies of the company in relation to those matters and the effectiveness of those policies.

If the report does not contain information of each kind mentioned in paragraphs (b)(i), (ii) and (iii), it must state which of those kinds of information it does not contain.

(8) In the case of a quoted company the strategic report must include—

- (a) a description of the company's strategy,
- (b) a description of the company's business model,
- (c) a breakdown showing at the end of the financial year—
  - (i) the number of persons of each sex who were directors of the company;
  - (ii) the number of persons of each sex who were senior managers of the company (other than persons falling within sub-paragraph (i)); and
  - (iii) the number of persons of each sex who were employees of the company.

(9) In subsection (8), "senior manager" means a person who—

- (a) has responsibility for planning, directing or controlling the activities of the company, or a strategically significant part of the company, and
- (b) is an employee of the company.

(10) In relation to a group strategic report—

(a) the reference to the company in subsection (8)(c)(i) is to the parent company; and

(b) the breakdown required by subsection (8)(c)(ii) must include the number of persons of each sex who were the directors of the undertakings included in the consolidation.

(11) The strategic report may also contain such of the matters otherwise required by regulations made under section 416(4) to be disclosed in the directors' report as the directors consider are of strategic importance to the company.

(12) The report must, where appropriate, include references to, and additional explanations of, amounts included in the company's annual accounts.

(13) Subject to paragraph (10), in relation to a group strategic report this section has effect as if the references to the company were references to the undertakings included in the consolidation.

(14) Nothing in this section requires the disclosure of information about impending developments or matters in the course of negotiation if the disclosure would, in the opinion of the directors, be seriously prejudicial to the interests of the company.

### **3.4 The applicable legal requirements – in practice for unquoted companies**

In reality there are five major elements to an unquoted company's strategic report. The questions that an auditor needs to ask are:

Q1 Does the strategic report contain a fair review of the company's business? S414C2(a)

Q2 Does the strategic report contain a description of the principal risks and uncertainties facing the company? S414C2(b)

Q3 Does the review give a balanced and comprehensive analysis of the development and performance of the company's business during the financial year consistent with the size and complexity of the business? S414C3(a)

Q4 Does the review give a balanced and comprehensive analysis of the position of the company's business at the end of that year, consistent with the size and complexity of the business? S414C3(b)

Q5 Does the review, to the extent necessary for an understanding of the development, performance or position of the company's business, include analysis using financial key performance indicators? S414C4(a)

### **3.5 Case study**

The following strategic report example is based on a real report for a medium-sized company with a turnover of £30m. The details have been changed enough so as not offend the company who wrote it.

Without the context of having done the audit or access to the full financial statements this will not be easy, but do you think that it has been prepared in compliance with s414c? When you ask the above five questions, is it good enough?

## **Example strategic report**

### **Clear Communications Limited**

Extract from the Strategic Report for the year-ended 30 June 2017.

#### **Fair review of the business**

The principal activity of the company during the year was that of the supply and manufacture of marine radio and communications equipment.

In the year, the company increased sales by 2% in comparison with the prior year.

The market was strong and the company performed well in the first six months of the year. However, as a result of movements in exchange rates and the economy in the Americas this was followed by a shrinking of the order books in the second half of the year. Despite the downturn at the end of the period, the company has still increased profitability as a result of the careful management of its direct costs and overheads.

The company continues to pursue business development opportunities in several market sectors for future growth and has seen this development continue during the period with continued success in new markets and involvement in activities for future revenues. Asia and particularly Japan have proved to be promising new areas of growth. These customers are believed to be worth a great deal in future years and represent development of new markets both in terms of geographical area and customer base.

#### **Principal risks and uncertainties**

This year has seen further development and support to other group companies based outside the UK where we continue to transfer product for production. In addition, we have also brought on board a North African joint venture to allow further expansion of our production base whilst also mitigating any risks through reliance on specific geographical areas of production.

Employee numbers have increased in the year due to the increase in demands for locally manufactured products. The company continues to invest heavily in the learning and development of its employees and has implemented many new initiatives to engage and retain key employees in terms of training and continuous improvement. In addition, the company's activities identify potential future skills gaps in order to ensure the company can meet the needs of both current and future customer requirements.

The company has won a number of important industry awards in the year including being recognised by its fellow manufacturing community through being awarded the Pyramid of Manufacturing Excellence in March 2017 and the Investment in Human Resources Award in September 2016.

Additional, stability has also been achieved in terms of overheads and direct costs as a result of continuous improvement activities, improvement in processes, strategic measures and development of activities to focus attention on the core business. New systems have enabled efficiencies to be achieved in stocking levels which has resulted in stock levels reducing from 2016 to 2017 despite maintaining current stock lines at agreed levels with customers allowing the company to continue to work towards achieving optimum stock levels.

### Development and performance

Whilst customer pressure will always be cost down, the company will continue to invest in continuous improvement activities which will enable the company to maintain and further improve profitability. The company has maintained accreditation for its internationally recognised quality control standards, including ISO9001, during the year, and has also actively looked at ways to improve operational activities in order to reduce the impact on the environment, resulting in the company being awarded runners up in the Ethical Business Awards.

The company continues to monitor market activities and KPIs such as order intake, order outstanding, aged debtors and creditors, stock values and turn, non-conforming products, delivery performance, customer pricing and product profitability and relationships with customers.

The directors believe that the company's success next year is reliant on global economic conditions in line with the company's current customer base but the directors remain optimistic that the company can continue to win new customers in different market sectors and continue to develop the business.

The directors will continue to monitor forward ordering in view of the current economic conditions and the company is well placed to be able to react to volume changes in order to maintain net profit percentages.

The company's strategy is to continue selling into its core market and increase market share by providing a value added service to customers. The company invests and targets new customers through our quality, costs, delivery and flexibility. We will continue to invest in training for our personnel.

Supply chain risk is reduced as the main source of our raw materials is via group central purchasing facility in Germany. The risk of logistical supply problems is reduced by the availability of core product held in stock in the UK and Italy. Furthermore, the company is well placed through its related companies throughout the work to be able to obtain labour for production between various global sites.

### 3.6 John Selwood's solution

You might have noticed that I need to take some personal responsibility for this solution. In my experience when talking about compliance in strategic reports, opinions can be divided on the subject. This is somewhat inevitable given the paucity of guidance on the matter and the resulting need to use professional judgement.

For what it's worth, this is what I think:

	Issue	John's answer
Q1	Does the strategic report contain a <u>fair review of the company's business</u> ?	<p>I give it a strong maybe.</p> <p>The second and third paragraph is fairly clear and with a little more detail I would be happy.</p> <p>I can just about accept the report as it is, as being compliant in this area, but I would rather it was slightly more specific and detailed</p>

Q2	Does the strategic report contain a <u>description of the principal risks and uncertainties</u> facing the company?	<p>I am going to say, no. I think the risks are inferred rather than expressly stated. Bizarrely, more words are dedicated to how the risks are addressed than describing the risk themselves.</p> <p>I can understand why some auditors might accept this, but I think the risks need to be more clearly set out.</p>
Q3	Does the review give a balanced and comprehensive analysis of the <u>development and performance</u> of the company's business during the financial year <u>consistent with the size and complexity of the business</u> ?	<p>No.</p> <p>What is missing for me, is balance. The 'fluffy stuff' on awards and improving the business, in my view, just clouds the more direct reporting.</p> <p>Also, the report is overly comprehensive which in my opinion leads to a lack of balance. The circumstances surrounding the shrinking of order books needed more focus and much of the rest of the report could have been lost.</p>
Q4	Does the review give a balanced and comprehensive analysis of the <u>position of the company's business at the end of that year, consistent with the size and complexity of the business</u> ?	<p>No.</p> <p>If any auditors think that the review of the position of the business at the year end is adequate, then show me where!</p> <p>I would expect terms like solvency, liquidity, cash balances, lines of credit and recoverability to be mentioned.</p> <p>I know that the shrinking order book is mentioned but I would like more detail on that.</p>
Q5	Does the review, <u>to the extent necessary</u> for an understanding of the development, performance or position of the company's business, include <u>analysis using financial key performance indicators</u> ?	No.