Stakeholder connections

Section 172 trends

Small and mid-cap reporting

designportfolio

Introduction

A timely arrival

Having dominated the UK corporate reporting agenda for nearly two years, mandatory Section 172 statements are now being published for the first time and no one could have imagined them arriving under more turbulent circumstances.

But rather than take away from the significance of the new disclosures, the ongoing COVID-19 crisis draws a sombre line under just how urgent Section 172 of the Companies Act 2006 really is. COVID-19 is an emergency that raises unprecedented questions about health and safety, workers' rights, supply chain resilience, environmental impacts, community reputation and the role of business in society at large.

The first mandatory Section 172 statements have also come at a time when environmental, social and governance (ESG) issues have exploded into the capital markets limelight.

As investor scrutiny continues to grow in this area, more and more focus will be placed on the strength of the relationships between businesses and their stakeholders, the responsibilities of directors and the long-term impact of their decisions.

Section 172 reporting is an opportunity to address these trends in a way that not only confirms your compliance with the Companies Act, but also reinforces your risk management disclosure, raises your ESG profile and revitalises your investment case.

Purpose of this report
We have extensive experience in partnering with small and mid-cap companies on their stakeholder communications and have produced this whitepaper to uncover the emerging trends shaping their Section 172 disclosures.

Find more about our work and insights at **design-portfolio.co.uk**

A recap on requirements

What is Section 172?

Section 172 of the Companies Act 2006 enshrines a director's duty to promote the success of their company, stating that:

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 between members of the company.

Large companies

Under the Companies (Miscellaneous Reporting) Regulations 2018, large companies are required to include the following disclosures in their annual reports:

- **Section 172 statement**
  A statement in the strategic report describing how the directors have had regard to the matters set out in Section 172 (a)-(f).
- **Additional directors' report disclosure**
  A statement in the directors' report summarising how the directors have engaged with suppliers, customers and others, and the impact of this on the company during the year.

Under the Companies Act, large companies are those that meet at least two of the following criteria: turnover of more than £36m; balance sheet total of more than £18m; more than 250 employees.

Companies with more than 250 people

UK incorporated companies with more than 250 UK employees must include a statement in the directors' report summarising how the directors have engaged with employees and taken account of their interests.

UK Corporate Governance Code reporters

The 2018 UK Corporate Governance Code requires companies with a Premium Listing on the London Stock Exchange – and those who voluntarily follow the Code – to report on a "comply or explain" basis how Section 172 matters have been considered in board decisions.

+ For further information on the new requirements see **page 11**

Your blueprint for Section 172

1

Connect the dots

Stakeholder engagement should not be a siloed discussion, whether in an annual report or across other communication channels. Illustrate how it links to your business model, strategy, sustainability framework, risk management and governance activities.

2

Think “decision useful”

The purpose of the strategic report is to provide information that helps shareholders assess how directors have performed their Section 172 duties. Focus on the most material stakeholder concerns and provide clear detail about how the board is responding to these topics.

3

Make it personal

The nature of a company’s relationships with stakeholders will be shaped by its culture. This means that your corporate purpose and values should be factored into how you approach and report on Section 172 duties.

4

Bring your story to life

It is sometimes easier to capture stakeholder relationships through a case study rather than a list of activities alone. Supplement your disclosure with these stories and leverage them as communications collateral beyond the annual report.

5

Be authentic

Section 172 disclosure is not a marketing exercise and should not attempt to hide the areas in which your company may need to improve. Discuss the steps your company is taking to understand and respond to challenges and plan for the future.

6

Avoid repetition

There is plenty of overlap between the new reporting requirements. Remember that you are free to cross reference between the strategic and directors’ reports to avoid saying the same thing twice.

The small and mid-cap challenge

Much of the coverage around the first Section 172 statements has focused on emerging FTSE 100 trends. However, in many cases small and mid-cap companies have had to meet the same requirements with more modest reporting, communication and company secretarial teams.

What's more, these teams are faced with a distinct set of market challenges that make it uniquely important for them to get Section 172 reporting right. Through our extensive experience in partnering with small and mid-cap companies, we can distil these into three distinct areas:

ESG rating biases

Investors are increasingly embracing ESG rating agencies as part of their strategies. These agencies typically cover an enormous universe of issuers and often base much of their analysis on publicly available historical disclosures. Inevitably, larger companies with more communication resources tend to score better.

This will change as investors become more sophisticated in their ESG analysis, but in the meantime, it is crucial for small and mid-cap companies to provide the information necessary to build their ESG credentials – including evidence of strong stakeholder relationships and informed board decision making.

Stranded narratives

More than two years after it came into effect, the impact of MiFID II on small-cap coverage remains unclear. However, anecdotal evidence suggests that the unbundling of research and broker services has indeed reduced analyst coverage in certain areas, if not by the drastic level that some predicted.

This continues to put pressure on small-cap companies to build a clear, consistent and compelling investment case that reaches investor and analyst audiences. In line with the ESG revolution and the COVID-19 corporate governance flashpoint, stakeholder relationships are a crucial component of this narrative.

Stakeholder sophistication

The rise of "stakeholder capitalism" is built on the growing influence of increasingly sophisticated stakeholder groups and ongoing demographic change. As employee, community and regulator expectations continue to evolve, it will become more and more difficult for companies to merely "talk the talk" of sustainability.

Section 172 requirements will put engagement activities up for debate at small and mid-cap companies where they might previously have been handled in a much less formal way. We expect to see a growing divide between companies who view the new regulation as a plain compliance exercise and those that embrace it as an opportunity to enhance stakeholder relationships.

Our findings

We have reviewed emerging Section 172 reporting trends across a sample group of 25 companies with a market cap of less than £1bn as of April 2020. These companies are listed on the FTSE 250, FTSE Small Cap, FTSE Fledgling and AIM All-Share indices and are reporting on the year ended 31 December 2019.

Our analysis focused on 50 data points covering the form and content of Section 172 compliance statements, along with additional stakeholder engagement disclosures.

Strong compliance, but what's the bigger picture?

Our research has found that the first Section 172 disclosures by small and mid-cap companies are concise, easily identifiable and broadly aligned with emerging large-cap trends.

> **A "compliance-first" approach is common in the first year of any new reporting requirement and we think that small and mid-cap companies have done a very commendable job in meeting the letter of the law. In the future, we expect to see companies further embracing the spirit of it too, which we are confident will have a considerable impact on both the quality of their reporting and the strength of their stakeholder relationships."**
>
> **Daniel Redman**
> Content and Strategy Director, Design Portfolio

Small and mid-cap disclosures tend to comprise a short compliance statement that mirrors the language of the Companies Act itself, supplemented by a table of information summarising the engagement methods, topics and outcomes for each stakeholder group.

These disclosures are effective at evidencing small and mid-cap stakeholder commitments as part of the annual report. However, they fall slightly short of capturing the "decision-useful" information that investors need to assess social and governance criteria. In particular, companies tend to:

→ refer to the "outcome" of their engagement with stakeholders, but often fail to evidence how their feedback has been factored into senior management or boardroom decisions;

→ signpost to content throughout the annual report that's relevant to Section 172 topics, but don't explain how stakeholder engagement is embedded in their capital allocation or risk management frameworks;

→ summarise the results of employee engagement surveys, but avoid identifying other metrics for measuring the effectiveness of their engagement activities; and

→ emphasise the importance of particular stakeholders, but lack content that speaks to these groups across other communication channels like their corporate website and social media.

76%

of companies provide more detail than just a simple statement confirming compliance with Section 172

What do small and mid-cap Section 172 statements look like?

The first Section 172 statements by small and mid-cap companies are clear, concise and well signposted within the strategic report.

Where are companies publishing their statements?

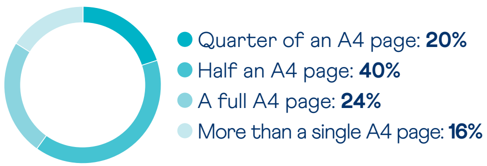
Some have argued that Section 172 reporting should take place in the directors' report given it covers directors' duties. But in line with the Companies (Miscellaneous Reporting) Regulations, most of our sample group have positioned their statements in the strategic report.

66% of these companies published it as part of their sustainability section, while 30% positioned it directly alongside their Non-financial Reporting Directive statement, indicating that they see Section 172 as an extension of mandatory sustainability disclosure.

How detailed are these statements?

All our sample group included a statement confirming that directors have fulfilled their duties under Section 172, but the majority went on to provide further insight into their stakeholder commitments and methods of engagement.

How long are these statements?



Excluding additional disclosure on the mechanisms and topics of engagement, most statements confirming that directors have fulfilled their Section 172 duties are under half an A4 page in length.

How many companies provide additional insight in their directors' report?

Just over half the companies in our sample group discussed the board's stakeholder engagement activities in the corporate governance statement, without simply repeating content from the Section 172 statement in the strategic report.

52% of companies provide additional insight in their directors' report

Provident Financial plc
Annual Report 2019
(pages 68 and 69, 83 to 87 and 107 to 113)

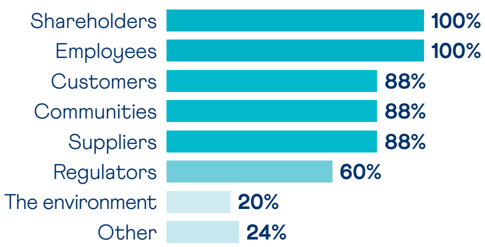
Provides a clear Section 172 statement alongside a breakdown of engagement activities by stakeholder group and frames its stakeholder commitments in the context of its corporate purpose. Provides links to where further information can be found, including a detailed description of why each stakeholder group is important.

Our findings

How do small and mid-caps report on specific stakeholders?

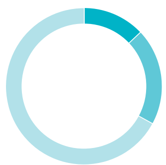
Companies often break down engagement activities by each of the stakeholder groups identified in Section 172.

Which stakeholder groups are most often identified?



96% of our sample group discussed engagement activities in relation to specific stakeholder groups, rather than confirming compliance with Section 172 as a whole.

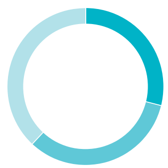
How are these stakeholder insights presented?



- Subsection (body text): **13%**
- Standalone section (body text): **20%**
- Standalone table: **67%**

Most companies use a tabular format to summarise engagement activities, topics and outcomes for each stakeholder group, often spreading across several pages in the report. The remainder discusses this information in plain text as either a subsection or standalone stakeholder engagement section.

Where are these stakeholder insights presented?



- As part of the Section 172 statement: **29%**
- Alongside the Section 172 statement: **33%**
- In a separate part of the report: **38%**

When summarising engagement activities by stakeholder group: just under a third of companies did so as part of the statement that confirms their compliance with Section 172; a third did so alongside the Section 172 statement but in a separate table or box; and over a third did so in an entirely different part of the report to where the Section 172 statement sits.

Belvoir Group PLC
Annual Report 2019 (page 29)

Provides a succinct insight into engagement activities by each stakeholder group as part of the Section 172 statement.

Marshalls plc
Annual Report 2019 (pages 18 and 19)

Summarises its engagement activities in a table alongside the Section 172 statement, with an overview of why it engages, through what activities, and how this links to the group strategy.

How do small and mid-caps tailor their reporting?

Companies often discuss the "why", "how" and "what" of engagement, but fall short of evidencing the impact of their activities.

What do companies discuss in their Section 172 statements?

68% Why the company engages with each group

92% How the company engages with each group

60% What the company discusses with each group

64% The result of engaging with each group

Is Section 172 referenced in the leadership statements or business model?

Only a fifth signpost to Section 172 from the business model, despite many using the model to summarise value created by the company for key stakeholder groups.

Do companies discuss purpose and culture in relation to Section 172?

Few companies discussed engagement in the context of their corporate purpose, culture or values. This is a missed opportunity to demonstrate how their businesses are aligned with stakeholder needs.

How many companies cover Section 172 online?

All our sample group complies with requirements by disclosing their statements in PDF format on their corporate websites. However only one took the content of their statement and presented it on a HTML webpage.

How many statements include signposts to other sections of the report?

92% direct readers to sections of the report where they can find further evidence of the company's stakeholder considerations. Most refer to sections that generally relate to Section 172 duties, while just over a third provided signposts to information that relates to specific stakeholder groups.

Go-Ahead Group plc
Annual Report 2019 (pages 22 to 33)
Provides an extended stakeholder section that aligns the group's impacts with the UN Sustainable Development Goals. Further information is provided in the directors' report.

Tullow Oil plc
Annual Report 2019 (pages 46 and 47)
Supplements its statement with case studies illustrating how directors have engaged with stakeholders during the year.

How we can help

We provide content, creative and channel guidance for companies of all sizes. Through our experience and expertise in stakeholder storytelling and ESG reporting, we offer our clients integrated Section 172 support, from stakeholder mapping and materiality assessments to copywriting and communication campaigns.

Additional resources

+ The Companies (Miscellaneous Reporting) Regulations 2018
+ Q&A on the Companies (Miscellaneous Reporting) Regulations 2018
+ The 2018 UK Corporate Governance Code
+ Guidance on the Strategic Report
+ Powerful communication goes hand in hand with ESG excellence

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