

EXPLANATORY MEMORANDUM TO
THE COMPANIES (STRATEGIC REPORT AND DIRECTORS' REPORT)
(AMENDMENT) REGULATIONS 2023

2023 No. [XXXX]

1. Introduction

- 1.1 This explanatory memorandum has been prepared by the Department for Business and Trade and is laid before Parliament by Command of His Majesty.

2. Purpose of the instrument

- 2.1 This instrument amends the Companies Act 2006 to introduce new company reporting requirements for companies with a high level of employees and turnover. The additional reporting requirements must be included in the Directors' Report and Strategic Report, within a company's annual accounts and reports, while an additional note to the accounts must set out information concerning the company's distributable profits, distributions, and purchase of own shares.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments.

- 3.1 None.

4. Extent and Territorial Application

- 4.1 The extent of this instrument (that is, the jurisdiction(s) which the instrument forms part of the law of) is England, Wales and Scotland. It will also extend by agreement to Northern Ireland.
- 4.2 The territorial application of this instrument (that is, where the instrument produces a practical effect) is England, Wales and Scotland. It will also apply by agreement to Northern Ireland.
- 4.3 The UK Government is responsible for the operation and regulation of business entities in England and Wales, and in Scotland. The Northern Ireland administration has agreed that, while the operation and regulation of business entities remains a transferred matter within the legislative competence of the Northern Ireland Assembly, amendments to the Companies Act 2006 and legislation regulating business entities should be made in the same terms for the whole of the United Kingdom.

5. European Convention on Human Rights

- 5.1 The Minister for Enterprise, Markets and Small Business, Kevin Hollinrake MP has made the following statement regarding Human Rights:

“In my view the provisions of the Companies (Strategic Report and Directors' Report) (Amendment) Regulations 2023 are compatible with the Convention rights.”

6. Legislative context

- 6.1 Part 15 of the Companies Act 2006 (Accounts and Reports) sets out a reporting framework for companies. The Act specifies information, both financial and non-financial, that companies are required to include in their annual reports. Subject to size criteria, companies are required to prepare a strategic report and a directors' report.
- 6.2 These Regulations introduce new reporting requirements for companies in Part 15 Chapter 4 (Annual Accounts), Chapter 4A (Strategic Report) and Chapter 5 (Directors' Report).
- 6.3 These Regulations apply to companies with a high level of employees and turnover which is defined as 750 or more employees and an annual turnover of £750 million or more.

7. Policy background

What is being done and why?

- 7.1 Corporate governance facilitates effective, entrepreneurial, and prudent management that can deliver the long-term success of a company. It involves a framework of legislation, codes, and voluntary practices. Periodic reviews and improvements have ensured that the UK framework has kept pace with business practices and with investors' and wider society's changing expectations of business, while maintaining the framework's international reputation.
- 7.2 The Government published a White Paper¹ on Restoring Trust in Audit and Corporate Governance on 18 March 2021. The White Paper responded to recommendations in three independent reviews that the Government established following a series of major corporate collapses between 2016 and 2019 (including Carillion and BHS), which raised questions about the reliability and effectiveness of the UK's audit and corporate governance framework. Those reviews were an Independent Review of the Financial Reporting Council² (the UK's audit regulator) by Sir John Kingman, a Statutory Audit Services Market Study by the Competition and Markets Authority³ and an Independent Review into the Quality and Effectiveness of Audit by Sir Donald Brydon⁴.
- 7.3 The White Paper included proposals to strengthen corporate reporting that were recommended by or related to recommendations made by the Brydon Review. On 31 May 2022, the Government published its Response to the White Paper consultation, setting out its final policy proposals. The final proposals on new corporate reporting, which are reflected in the Regulations, are set out below.

Explanations

- 7.4 **Inclusion of information about distributable profits in a note to the annual accounts and a distribution policy statement in the Directors' report.** Distributable profits are a company's accumulated realised profits minus its accumulated realised losses. The Companies Act 2006 requires that dividends and other distributions may only be made from distributable profits and imposes various

¹ <https://www.gov.uk/government/publications/restoring-trust-in-audit-and-corporate-governance>

² <https://www.gov.uk/government/publications/financial-reporting-council-review-2018>

³ <https://www.gov.uk/cma-cases/statutory-audit-market-study>

⁴ <https://www.gov.uk/government/publications/the-quality-and-effectiveness-of-audit-independent-review>

other restrictions on distributions. Companies are not currently required to disclose their distributable profits, meaning that investors and other readers of the accounts have no way of knowing whether companies have sufficient distributable reserve to pay a dividend, nor what headroom exists between dividends paid (or proposed) and the amount available. The inclusion of the distributable profits figure as a note to the accounts means that they will be subject to statutory audit. In addition, as part of the Directors' report, directors will be required to set out their policy towards the amount and timing of distributions to shareholders over the short and medium term, including the purchase of a company's own shares. This policy statement will also consider the risks and constraints relevant to implementing and sustaining the distribution policy and how the policy has been applied, taking into account amongst other things, the availability of distributable profits and other restrictions which may apply.

- 7.5 **Inclusion of a Resilience Statement in the company's Strategic Report.** The strategic report requires companies to provide a 'description' of their principal risks and uncertainties but companies are not required to provide detail of how such risks are being managed. The Resilience Statement will require this extra detail, including any mitigating action in place to address the disclosed risks, and their estimated likelihood and impact. As part of this the Resilience Statement will require a brief explanation of the company's internal governance processes covering risk management and the carrying out of an annual 'reverse stress test', in which the company tests a scenario in which the business plan would fail and seeks to learn lessons from that.
- 7.6 **Inclusion of an Audit and Assurance Policy statement in the Directors' report.** The Audit and Assurance Policy statement responds to investor and other concerns that statutory audit is primarily concerned with assuring the reliability of the company's financial statements and accounts. Other information in the annual report such as risk, strategy and governance is of increasing importance to investors and other stakeholders. The Regulations therefore require companies to set out, every three years, their plans for assuring the reliability of information in the annual report beyond the accounts, including whether any external (third party) assurance is planned.
- 7.7 **Inclusion of a material fraud statement in the Directors' report.** The Regulations require the annual disclosure of a summary of the directors' assessment of the risk of material fraud and a description of the main measures in place, or proposed, to prevent and detect the occurrence of material fraud. The board and management of a company are primarily responsible for the prevention and detection of fraud in the company's business operations. The new reporting is intended to underline this responsibility and to encourage all boards to think carefully about this aspect of their responsibilities as well as provide reassurance to investors that the risk of material fraud is being properly considered and managed.

Alternatives to legislation

- 7.8 Non-legislative measures were fully considered. For example, a non-legislative option would be for the Financial Reporting Council to introduce the new reporting on a 'comply or explain' basis through the UK Corporate Governance Code. However, this Code only applies to certain UK listed companies, and applies to those companies regardless of size, whereas the Government's policy intention is to seek the new disclosures from large companies, with a high level of employees and turnover, whether listed or unlisted.

8. European Union Withdrawal and Future Relationship

8.1 This instrument does not relate to withdrawal from the European Union.

9. Consolidation

9.1 The Department does not intend to consolidate the Regulations.

10. Consultation outcome

10.1 The new note to the accounts and the additional statements to be attached to the Strategic and Directors' Reports were finalised following a sixteen-week consultation on the White Paper. The White Paper asked for views on proposals to introduce a new statutory Resilience Statement and a new statutory Audit and Assurance Policy. Additionally, it proposed new reporting obligations for directors, reporting on material fraud and distributable profits.

10.2 The Government's response was published on 31 May 2022. It included an assessment of the views of the respondents and the Government's conclusions, including how the original proposals had been modified in the light of business, investor and other stakeholder feedback.

10.3 The detailed content of the reporting requirements has been in development since the publication of the Government's response. This has involved two phases of informal consultation with a balanced set of impacted and expert stakeholders.

11. Guidance

11.1 These Regulations are not accompanied by formal Guidance. However, the Financial Reporting Council will provide full guidance on the new reporting requirements. This will be consulted upon in draft and is expected to be published in its final form in 2024 before the reporting requirements come into effect.

12. Impact

12.1 The impact on business, charities or voluntary bodies is an estimated equivalent annual net cost of £53.2m. The measures affect around 750 companies. There is no impact on charities or voluntary bodies unless they satisfy the definition of a company with a high level of employees and turnover, in which case the impact on these organisations is included in the total costs for business described above.

12.2 The measures aim to reduce the costs of insolvency, including the costs to government and the Pensions Regulator. Further, companies themselves should benefit from a clearer understanding of the risks they are taking. It is estimated that a relatively small change in avoided losses to creditors from a Carillion-style event over the next 10 years would more than balance the costs of the reform package.

12.3 There is no, or no significant, impact on the public sector.

12.4 A full Impact Assessment is submitted with this memorandum and published alongside the Explanatory Memorandum on the [legislation.gov.uk](https://www.legislation.gov.uk) website.

13. Regulating small business

13.1 The legislation does not apply to activities that are undertaken by small businesses.

14. Monitoring & review

- 14.1 The approach to monitoring of this legislation is the Government will monitor how companies respond to the new reporting requirements. Monitoring will include reviewing examples of relevant company reporting.
- 14.2 A statutory review clause is included in the instrument. The Regulation provides for a review before 1 January 2030 with subsequent reviews at intervals not exceeding five years.

15. Contact

- 15.1 Robin Mueller at the Department for Business and Trade, telephone: 07500 890 872 or email: robin.mueller@beis.gov.uk, can be contacted with any queries regarding the instrument.
- 15.2 Mark Holmes, Deputy Director for Corporate Governance, Audit Reform and Shareholder Rights, at the Department for Business and Trade can confirm that this Explanatory Memorandum meets the required standard.
- 15.3 Kevin Hollinrake, Minister for Enterprise, Markets and Small Business at the Department for Business and Trade can confirm that this Explanatory Memorandum meets the required standard.