NARRATIVE REPORTING

It has long been established that a set of company accounts should be accompanied by a directors' report that provides additional information about the company that may be of interest to its shareholders.

In recent years there has been a series of developments that have increased the amount of information that companies have had to include as part of their annual report. These narrative reporting obligations provide an opportunity for management to aid users of the financial statements in their understanding of the company, its activities and performance.

This will not be achieved by including standard or 'boilerplate' wording that solely aims to ensure that the legal requirements have been met. Rather directors need to carefully consider what they disclose to not just meet their regulatory obligations, but also to provide narrative that is useful and meets the needs of the users of the financial statements, which increasingly can represent a wide range of the company's stakeholders and not just its shareholders.

This factsheet aims to provide a clear explanation of the narrative reporting requirements faced by private companies.

Company size

The key to understanding your company's requirements is to first ascertain its size. The narrative reporting requirements become more onerous as a company increases in size.

The size limits relating to periods commencing prior to 6 April 2025 are as follows:

	Micro	Small	Medium
Turnover	£632,000	£10.2m	£36m
Total assets	£316,000	£5.1m	£18m
Employees	10	50	250

For periods commencing on or after 6 April 2025, some of these limits will increase, per the below:

	Micro	Small	Medium
Turnover	£1m	£15m	£54m
Total assets	£500,000	£7.5m	£27m
Employees	10	50	250

A company needs to meet two out of three of the above criteria for two consecutive years to qualify as a micro, small or medium-sized company, unless it is the first year of the company's existence, in which case only that year has to be considered. The turnover limit is adjusted if the financial year is longer or shorter than twelve months.

There are certain exclusions from the above size limits which are set out in the Companies Act 2006. In addition special rules apply to parent undertakings which need to be taken into account.

Micro-entities

Companies that meet the micro-entity size criteria, and have opted to prepare their annual report in accordance with the micro-entity provisions, have no narrative reporting requirements due to the simplified arrangements that exist for such companies.

In practice many companies, despite meeting the size criteria, find the reporting requirements for micro-entities inappropriate for their needs, and voluntarily choose to prepare their annual report using the small-entity provisions instead. In such circumstances they will be subject to the narrative reporting requirements applicable to small entities.

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Small entities

Companies that are able to and choose to adopt the small-entity reporting provisions are required to include a directors' report as part of their annual report that is distributed to the company's members. Note though that the directors' report does not need to be included as part of the annual report that is filed at Companies House: it (and the profit and loss account) can currently be removed from the annual report in a process commonly known as filleting.

The directors' report of a small company is required to include the following:

- The names of all the directors who held office at any time during the financial year. It is also common practice to include details of any changes to the board that have arisen since the year end.
- Whether any qualifying third party indemnity provision is in force at the time of the approval of the report or during the period, for the benefit of one or more directors.
- Unless the company is a wholly-owned subsidiary undertaking of a UK parent company, details of any political donations made or similar expenditure where the total amount incurred exceeds £2,000. In addition the total contributions paid to non-UK political parties should be disclosed.
- Where the average number of employees exceeds 250, the company's policy for the employment of disabled persons.

Although not required, many small companies will also provide a brief description of the company's trading activity.

A statement that advantage has been taken of the small companies exemptions in preparing the directors' report is also required, which is presented immediately above the signature of the director or secretary who is signing the report on behalf of the board.

Medium and large size entities

Both medium and large size entities have considerably more onerous narrative reporting requirements when compared to small entities, and there is no exemption available to them when filing their annual report with Companies House.

The most significant difference is the need to incorporate a strategic report as part of the annual report. There are also additional requirements for the directors' report that will need to be addressed.

The reporting requirements are in the process of being enhanced, with additional disclosures being introduced. Before these are considered though let's examine the existing narrative reporting requirements.

Strategic report

For a private limited company the strategic report should contain the following:

- A fair review of the company's business. This should include a balanced and comprehensive analysis of the company's development and performance during the year and its financial position at the end of it. It may be necessary for the review of the business to include references to or provide additional explanation to amounts included in the accounts themselves.
- A description of the principal risks and uncertainties faced by the company.
- An analysis of the key performance indicators (KPIs) used by management to assess the company's performance. For medium-sized companies this is restricted to financial KPIs, but large companies are required to include non-financial KPIs such as those related to employee or environmental matters.

For parent companies preparing consolidated accounts the strategic report is required to consider the group's performance and not just that of the company itself.

Directors' report

A medium or large company is required to include in its directors' report all of the matters that a small company has to include, but also has the following additional requirements:

- The dividend recommended by the directors.
- An indication of the company's financial risk management objectives and policies and the exposure to price, credit, liquidity and cash flow risk when considered material to the assessment of the company's assets, liabilities, financial position and profit or loss.
- Important events that have occurred since the year end.

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- Likely future developments in the company's business.
- Research and development activities.
- An indication of the existence of any branches of the company outside the UK.
- Where the average number of employees exceeds 250, a statement describing the action taken during the year to introduce, maintain or develop arrangements aimed at informing and consulting with employees, including any how employee involvement is encouraged through share incentive schemes or similar arrangements.

Often it will make sense for the company to present information required to be included within the directors' report as part of the strategic report. This is permitted, provided that there is a clear cross reference to the disclosures that have been included as part of the strategic report within the directors' report.

Also required to be included is a statement of how the directors have complied with their duty to have regard to the matters set out in section 172 (1)(a)-(f) of the Companies Act 2006. This refers to the requirement that a director of a company must act in the way he or she 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:

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

This disclosure will need to reflect the issues, factors and stakeholders the directors consider relevant to their decision making, the main methods used to engage with stakeholders and understand the issues to which they must have regard, and information on the effect of that regard on the company's decisions and strategies during the financial year.

Note that this statement will also need to be published on the company's website.

The regulations also have the following implications for the directors' report:

- Where the average number of employees in the UK exceeds 250 a summary of how the directors have engaged with employees and had regard to employee interests, including the effect of this engagement on the principal decisions taken during the year. This builds upon the existing requirement to disclose details of employee involvement.
- Large companies are required to summarise how the directors have fostered engagement with suppliers, customers and others in a business relationship with the company, again including the effect of this on the company's principal decisions.
- The need to include a statement giving certain details about the corporate governance arrangements applied by the company. This only applies to companies with either more than 2,000 employees globally or which have turnover in excess of £200 million and total assets over £2 billion.

Companies subject to audit

Most small companies will be able to take advantage of audit exemption, but medium and large companies will be subject to the requirement to have their accounts audited. For those companies that are required to have their accounts audited, or choose to do so voluntarily, there are two additional requirements:

- A statement concerning the directors' responsibility for the preparation for the financial statements.
- A statement that all directors at the time of the approval of the report are not aware of any relevant audit information that the company's auditor is unaware of, and that appropriate steps have been taken to establish this.

These statements are often included as part of the directors' report. The statement of the directors' responsibility for the preparation of the financial statements can be presented separately if desired.

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Environmental reporting requirements

As part of the need to address climate change and encourage companies to consider their responsibilities towards the environment, companies are required to include disclosures in their directors' report on environmental matters.

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For low energy users, that is a large company which has consumed 40MWh or less of energy in the UK (including offshore areas), the directors' report merely needs to state that energy and carbon information is not being disclosed as it is a low energy user. In assessing whether the 40MWh threshold is met large companies must consider all the energy from gas, electricity and transport fuel usage. For parent companies the energy consumption of the parent and its subsidiaries must not exceed 40MWh if it is to qualify as a low energy user.

Large companies that do not qualify as low energy users will need to disclose the following:

- The UK annual quantity of emissions in tonnes of carbon dioxide equivalent from activities for which the company is responsible involving combustion of gas or consumption of fuel for the purposes of transport.
- The UK annual quantity of emissions in tonnes of carbon dioxide equivalent resulting from the purchase of electricity for its own use, including for the purposes of transport.
- The aggregated figure in kWh of the UK annual quantity of energy consumed from activities for which it is responsible involving combustion of gas or fuel for the purposes of transport, and the purchase of electricity for its own use, including for the purposes of transport.
- The methodology used to calculate its energy consumption and emission levels.
- At least one ratio that expresses the company's annual emissions in relation to a quantifiable factor associated with the company's activities.
- If the company has taken any measures for the purpose of increasing the company's energy efficiency, a description of the principal measures taken.
- Where it is impractical to obtain all or some of the emissions or energy consumption data requiring disclosure, what information is not included and why.

Although this new requirement only applies to large companies (and limited liability partnerships (LLPs)) other entities are encouraged to consider whether it would be helpful to the users of their financial statements to also make these disclosures. For LLPs, the disclosures are presented in an 'Energy and Carbon Report'.

Clearly these disclosure requirements are going to prove challenging to many companies. The Government had produced detailed guidance to assist companies meet their obligations which is available online using the following link:

https://www.gov.uk/government/publications/environmental-reporting-guidelines-including-mandatory-greenhouse-gas-emissions-reporting-guidance

How we can help

We will be very pleased to discuss the impact on your company of the narrative reporting requirements outlined above. If you would like to discuss these issues in more detail, please contact us.

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