EXPLANATORY MEMORANDUM TO

THE COMPANIES, PARTNERSHIPS AND GROUPS (ACCOUNTS AND NON-FINANCIAL REPORTING) REGULATIONS 2016

2016 No. XXXX

1. Introduction

1.1 This explanatory memorandum has been prepared by the Department for Business, Enterprise and Industrial Strategy and is laid before Parliament by Command of Her Majesty.

2. Purpose of the instrument

2.1 The Regulations implement aspects of Directive 2014/95/EU on disclosure of non-financial and diversity information by certain large undertakings and groups ("NFRD") and Directive 2013/34/EU on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings.

2.2 The NFRD imposes an obligation on certain large undertakings which are public interest entities (banks, insurers, financial services and listed companies etc.) and have more than 500 employees, to disclose a range of non-financial information. The Regulations also permit disclosure of this information on a voluntary basis. The Regulations also provide that there is no exemption from the requirement to produce group accounts under section 399 of the Companies Act 2006 (c. 46) for an undertaking which is part of a small group that has a public interest entity which is established in an EEA State as a member.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None.

Other matters of interest to the House of Commons

3.2 The territorial application of this instrument includes Scotland and Northern Ireland.

4. Legislative Context

4.1 The Regulations amend Part 15 of the Companies Act 2006 ("the 2006 Act"), in order to implement article 1(1) and (3) of the NFRD and to complete transposition of article 23(1) of the Accounting Directive.

4.2 Article 1(1) and (3) of the NFRD amends the Accounting Directive, and inserts a new requirement for certain large public interest entities to disclose certain non-financial information in a statement as part of the entity's management report. Where the public interest entity is the parent of a group, the information must be presented by the parent in consolidated form as a group statement. If the information for the undertaking and its subsidiaries (if any) is included in the management report of a parent of the undertaking, then the information need not be included in the undertaking's management report.

4.3 There are existing requirements in Part 15 of the Companies Act concerning the provision of non-financial information, as part of the strategic report of a company, see sections 414A to 414D. These requirements reflect a mixture of domestic and EU law requirements. The strategic report forms part of the 'management report' referred to in the Directive.

4.4 The new requirements have been deliberately kept separate, and added on top of the existing requirements, as the Directive requirement is to have a non-financial information statement as a distinct part of the management report. However, certain information requirements in newly inserted section 414CB are treated as satisfying certain of the requirements in section 414C to prevent duplication.

4.5 The government are only concerned with this transposition to impose obligations on companies that are obliged to produce accounts and strategic reports in the UK, i.e. which are established in the UK (as EEA established businesses will have to produce accounts in their home State). 'Public interest entity' is not defined for the purposes of Part 15 of the 2006 Act, but it is implemented by way of ensuring that all public interest entities which are UK established companies have been captured. To do this, the instrument uses domestic law concepts, rooted mainly in terms of authorisation under the Financial Services and Markets Act 2000 (FSMA 2000) to carry out the activities that public interest entities carry out. Part 4A of FSMA 2000 requires that permission is obtained in order to provide 'regulated activities'. 'Regulated activities' are defined in section 22 of FSMA 2000, supplemented by Schedule 2 to that Act and by the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544) made under section 22.

4.6 Looking at the definition of 'public interest entity' in Art 2(1) of Directive 2013/34/EU, and each limb of that definition, the instrument deals with each element as follows.

4.7 For the first limb, the domestic company law concept is a 'traded company', defined in s474(1) of the 2006 Act as a company any of whose transferable securities are admitted to trading on a regulated market. 'Regulated market' is defined in section 1173(1) of the 2006 Act, and 'transferable securities' is defined in section 1173(1) of that Act. Both definitions use cross-references to Article 4.1(14) of Directive 2004/39/EC, matching the definition in the first limb.

4.8 For the second limb, the domestic company law concept is a 'banking company', defined in section 1164(2) and (3) of the 2006 Act. A banking company is a person who has permission under Part 4A of FSMA to accept deposits. "Credit institution" is defined in the second limb by reference to Article 4 of Regulation (EU) No 575/2013, which provides that credit institution means an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account. This has been transposed in the UK by the need for permission under Part 4A of FSMA 2000 to accept deposits. See also the provisions of SI 2001/544 concerning the acceptance of deposits, in particular regulation 5.

4.9 For the third limb, it cross-refers to Article 2(1) of Council Directive 91/674/EEC, which cross-refers to other Directives which have been repealed and replaced by the Solvency 2 Directive (Directive 2009/138/EC). The department's view is that Article 2(1) should be interpreted as referring to undertakings within the scope of Solvency 2, providing direct non-life or life insurance business and reinsurance business within the scope of Solvency 2. The relevant domestic company law concepts are an

'authorised insurance company' (which by section 1165(2) of the 2006 Act is a person who has permission under Part 4A FSMA 2000 to effect or carry out contracts of insurance), and a person who carries on insurance market activity (see section 1165(3)(b)(i) and (7) of the 2006 Act). 'Insurance market activity' has the meaning given in s316(3) of FSMA 2000, which provides that it means a regulated activity relating to contracts of insurance written at Lloyd's. What is a 'contract of insurance' is set out in detail in articles 3 and 10 of, and Schedule 1 to, SI 2001/544, which transposes the Solvency 2 requirements in this regard. "Reinsurance" is just another form of "effecting and carrying out a contract of insurance".

4.10 For the fourth limb, there are no such bodies in the UK, and no statutory mechanism for designating such bodies (other than by using the European Communities Act 1972). Therefore when dealing with domestic companies, there is no need to make provision for companies within the fourth limb.

4.11 The Regulations also make amendments to the 2006 Act to remedy a gap in the transposition of article 23(1) of the Accounting Directive that has been identified. Transposition of that Directive was contained in the Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015 (S.I. 2015/980) The amendments are to ensure that the parent company of a small group cannot benefit from an exemption from the requirement to produce group accounts if a member of the group is established in an EEA state and is a public interest entity (within the meaning of the Directive).

4.12 The NFRD was first considered and reported on by the European Scrutiny Committee on 21 May 2013. The Committee held the Directive under scrutiny as the proposals gave rise to a number of issues, including costs to business and doubts regarding whether a minimum level of comparability in terms of non-financial disclosure was essential. The Directive was cleared by the Committee on 26 March 2014 in response to further information from the Minister as regards the significant reduction in costs of the proposal, as compared to the original version put forward by the Commission.

5. Extent and Territorial Application

5.1 The extent of this instrument is the United Kingdom.

5.2 The territorial application of this instrument is the United Kingdom.

6. European Convention on Human Rights

6.1 The Minister for Small Business, Consumers and Corporate Responsibility has made the following statement regarding Human Rights:

"In my view the provisions of The Companies, Partnerships and Groups (Accounts and Non-Financial Reporting) Regulations 2016 are compatible with the Convention rights."

7. Policy background

What is being done and why

7.1 The Government's overarching aim is to make the UK the best place in the world to start and grow a business. It is recognised that this can be achieved in part by ensuring that regulation achieves its objectives without placing unnecessary burdens on business.

7.2 The NFRD imposes an obligation on certain large undertakings which are public interest entities (banks, insurers, financial services and listed companies etc.) and have on average more than 500 employees during their financial year, to disclose a range of non-financial information. This obligation broadly mirrors the UK's requirement for an Enhanced Business Review which applies to all the of UK's listed companies regardless of size or number of employees. The term used in the Regulations to identify employees is those who are "employed under contracts of service". This is to match the wording of the 2006 Act in sections 382 and 465, and will include all those subject to contracts of employment, but will not include those who may be acting under a contract for services, such as consultants.

7.3 Those undertakings (mostly companies) in scope of the NFRD in the UK are required to include business specific disclosure on environmental, employee, social, community and anti-corruption and bribery matters, and respect for human rights**.** In making these disclosures the undertakings should include:

- a description of the undertaking's business model;
- a description of the policies pursued by the undertaking in relation to the matters mentioned above, including any due diligence processes implemented by the undertaking ;
- a description of the outcome of those policies;
- a description of the principal risks relating to the matters mentioned above arising in connection with the undertaking's operations including, where relevant and proportionate, a description of its business relationships, products and services which are likely to cause adverse impacts in those areas of risk, and a description of how the undertaking manages those risks;
- a description of the non-financial key performance indicators relevant to the undertaking's business.

7.4 Companies who do not pursue a policy in one or more of the areas subject to disclosure must provide a clear and reasoned explanation for not doing so. Where the undertaking is the parent of a group it must disclose the information for the group of which it is a parent.

7.5 In addition, companies with a listing on an EU recognised exchange, such as the main market of the London Stock Exchange, must include a description of their diversity policy, how it has been implemented, the risks to the policy and the outcomes. Companies not pursing a diversity policy must provide an explanation as to why. This aspect is however implemented by way of rules made by the Financial Conduct Authority which apply to listed companies.

7.6 Some UK companies may consider that it would be in their interests to report voluntarily under the harmonised EU framework to avoid the costs and complexities of moving between reporting obligations during their lifecycle as their size (in financial terms and/or number of staff) increases or decreases year to year. Therefore, the Regulations exempt companies voluntarily reporting under the EU framework from the comparable elements of the UK's existing regime.

7.7 On 23 June, the EU referendum took place and the people of the United Kingdom voted to leave the European Union. Until exit negotiations are concluded, the UK remains a full member of the European Union and all the rights and obligations of EU

membership remain in force. During this period the Government will continue to negotiate, implement and apply EU legislation and take note of Commission reports.

Consolidation

7.8 Since the Regulations amend the Companies Act there is no scope for consolidation.

8. Consultation outcome

8.1 Throughout the negotiation and development of the Directive, the Department for Business, Innovation and Skills (now Business, Energy and Industrial Strategy (BEIS)) informally consulted interested parties on the impact of the non-financial reporting requirements. The views of stakeholders helped inform this process.

8.2 A public consultation ran from 16 February to 15 April 2016 for 8 weeks to seek views on the Department's approach to implementation. The majority of responses were received from companies and business representative bodies, lawyers and accountants. However responses were also received from non-Governmental organisations and Trade Unions.

8.3 The consultation drew attention to all areas of mandatory change and explored the key question of how the requirements should fit with the UK's existing non-financial reporting regime and, in particular, to which companies it should be applied and requested information on impacts on business.

8.4 BEIS provided two implementation options:- Option 1, a minimalist option transposing the NFRD as a subset of the current UK framework; and Option 2, a deregulatory option repealing the UK's Enhanced Business Review for listed companies outside the scope of the NFRD. The consultation document also invited thoughts on alternatives we should consider.

8.5 In total 76 responses were received. The department had broad support for the implementation of the Directive. There was one area of controversy with stakeholders as some were in favour of applying the Directive to all listed companies as well as the small amount of private companies that are in scope. This would remove the small differences between the EU and domestic regime and so avoid a dual reporting system.

8.6 However obliging undertakings and groups outside the scope of the Directive to report under the new framework would go beyond the minimum requirements of the Directive, place a greater burden on these undertakings and groups and effectively "gold plate" an EU requirement. Therefore, the Regulations only require undertakings and groups that fall within the scope of the Directive to report in accordance with the requirements in the Directive (Option 1 in the consultation) .

8.7 Undertakings and groups outside the scope of the Directive will continue to be required to comply with the current UK requirements. However, we wish to avoid a situation where an undertaking or group may, because of a change in size of their workforce for example, report using the UK framework one year and the EU's the next. Therefore, the Regulations permit undertakings and groups to voluntarily comply with the EU requirements and exempt those who do so from the comparable domestic provisions. This will avoid undertakings and groups at the margins of the Directive's scope incurring additional costs as a consequence of moving between regimes due to changes in their size year to year.

9. Guidance

9.1 The implementation of the Regulations will be supported by the Financial Reporting Council's Guidance on the Strategic Report. Guidance on the revised framework for qualifying partnerships will be available from Companies House.

10. Impact

10.1 The impact on business will cost £11.6 million (on an annual basis over ten years).

10.2 There is no impact on the public sector apart from some familiarisation costs to Companies House.

10.3 An Impact Assessment is submitted with this memorandum and will be published alongside the Explanatory Memorandum on the legislation.gov.uk website.

11. Regulating small business

11.1 The legislation applies to activities that are undertaken by small businesses.

11.2 The only aspect of the Regulations that affects small business is the amendment to the 2006 Act to remedy an omission from the Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015 (S.I. 2015/980), to ensure that the parent company of a small group cannot benefit from an exemption from the requirement to produce group accounts if a member of its group is established in another EEA state and is a public interest entity. These amendments fulfil the requirements of the Accounting Directive. This is likely to affect a very small group of preparers and users of accounts, which is essentially a professional audience and will have a very limited impact. Furthermore it effectively reverts to the status quo for the affected companies.

12. Monitoring & review

12.1 In accordance with sections 28(2)(b) and 31(2)(b) of the Small Business, Enterprise and Employment Act 2015 (c. 26), the Minister for Small Business, Consumers and Corporate Responsibility has made the following statement:

12.2 "I consider that it is not appropriate to make provision for review of the amendments to the Companies Act 2006 made by the Companies, Partnerships and Groups (Accounts and Non-Financial Reporting) Regulations 2016, as the Regulations are amending regulatory provision that is contained in primary legislation, which is outside the scope of the policy objectives as set out in the statutory guidance."

12.3 However, the Department will keep the effect of the non-financial reporting requirements under review. The criteria for success for assessing the amendments made by the Regulations are firstly that the disclosures on those currently reporting improve the content of non-financial disclosures in particular regarding the reporting of policies of undertakings and groups on anti-corruption measures, risk management, performance and diversity. This should deliver a reporting regime for eligible undertakings and groups that encourages greater transparency and a platform for responsible corporate behaviour is in the interests of other stakeholders such as creditors, investors and regulators.

12.4 The review will also look at whether EU and domestic non-financial reporting regimes have led to unnecessary complexity for business.

13. Contact

13.1 John Conway at the Department for Business, Energy and Industrial Strategy Telephone: 020 7215 6402 or email: john.conway@beis.gov.uk can answer any queries regarding the instrument.