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Annual report insights 2014 – Providing a clear steer

The highlights

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Contents

Annual report insights 2014 – Providing a clear steer: The highlights

This half of the booklet is an abbreviated version of our publication 'Providing a clear steer', a survey of 100 listed companies' annual reports. It presents our key findings, split between narrative reporting, corporate governance disclosures and the financial statements. The full publication provides more detailed insight into companies' existing corporate reporting practices, what the best reporters are doing and more examples of how they are grappling with the regulatory changes and embracing innovation.

The other half of this booklet, *A clear steer for your annual report*, details regulatory changes in 2014, regulators' current areas of focus and, if you're so inclined, effective ways to go above and beyond in your reporting.

Executive summary

Veronica Poole, head of UK corporate reporting within Deloitte, and William Touche, UK head of corporate governance within Deloitte, draw from their experience of the year, share their insight and thoughts on the highlights from the survey and look at the challenges ahead.

Q: How well did companies cope with all the changes last year?
A: Overall I think they did well. All hundred companies surveyed included a strategic report. While we had hoped that the size of annual reports would start to fall, instead they have risen from 122 to 132 pages, driven by an increase in the length of narrative reporting, in particular the new style remuneration reports. Somewhat disappointingly there was a continued lack of cohesiveness, or in the FRC's words linkage, between the story told in the narrative and the numbers in the back. Whilst the majority of companies made efforts to link some parts of their annual report, in particular the discussion around strategy to their KPIs, only 29% showed up-front, in their summary pages, how their report as a whole linked together. But all in all, companies are making steps in the right direction!

132
pages was the average report length

Q: What does the survey tell us about non-GAAP measures?
A: 86% of companies presented non-GAAP measures in their summary pages and, of those, more than 60% gave them more prominence than the associated GAAP measures. 68% of companies also used them on the face of the profit and loss account. These findings will not please regulators and preparers should keep their eyes peeled for ESMA guidance due out before the end of 2014.

68%
used non-GAAP measures on the face of the P&L

Q: What were the key corporate governance messages from the survey?
A: It was quite surprising that only 57% of companies reported they were fully compliant with the UK Corporate Governance Code – the same level as in the prior year. The most common areas of non-compliance are around the independence of directors and the composition of audit committees. And they are making slow progress on getting women into the boardroom. 73% of companies have a woman on the board but the overall number of female directors in our sample companies remained disappointing, only rising from 13% to 15%. As in the past, there is still a need to boost the number of female executive directors on UK boards.

57%
reported full code compliance

Q: This last year saw the introduction of the requirement for the directors to state that the report and accounts were "fair, balanced and understandable". How well did companies cope with that?

A: All but four of the companies in our sample included the statement, typically in the directors' responsibility statement. What was encouraging was that 23% chose to provide some description of the process they had undertaken to support the statement by the board. We hope that this enhances shareholder confidence that the new requirement was taken seriously and that the governance of the annual reporting process was robust.

96

companies included the fair, balanced and understandable statement

Q: What were the highlights in the financial statements?

A: A few companies are innovating in areas like presentation of accounting policies and are including narrative reporting in their financial statements. And, even though there was pressure to cut clutter, some companies still included voluntary disclosures. Some 44% included net debt reconciliations and 10% included insight on tax governance and strategy.

44%

included a net debt reconciliation

Q: What challenges lie ahead?

A: 2014 will be the first year that many companies have had the IASB's package on consolidations to deal with, including all the new disclosures required by IFRS 12. The FRC's finalised guidance on risk management and internal control is now out and companies are going to need to look closely at this, the governance implications of the going concern changes and the revisions to the Code, all of which have effect for periods commencing on or after 1 October 2014. Country-by-country reporting will also have a big impact for those in the extractive industries for periods commencing on or after 1 January 2015.

All but four of the companies in our sample included the [FBU] statement, typically in the directors' responsibility statement. What was encouraging was that 23% chose to provide some description of the process they had undertaken to support the statement by the board.

80%
discuss value creation in their reports

Q: Finally, did integrated reporting feature much in companies' reports?
A: With the focus on growth, long term investment and the broader role of business in the society, integrated reporting offers an excellent opportunity for companies to tell their value creation story. Although only five companies surveyed mentioned integrated reporting, the vast majority, 80%, already discuss value creation in their reports. Of course, integrated reporting is not really just about reporting, it is about integrated thinking and behaviours, integrated from strategy and business model to business performance, from internal performance management measures to external reporting.

The strategic report framework in the UK creates an excellent enabling environment and allows companies to experiment and innovate. Our survey and its findings will also help companies to innovate and enhance their reporting by drawing on the many best practice examples we have provided. Hopefully, with the developments around integrated reporting and the FRC's encouragement for clear and concise reporting companies will feel empowered in their efforts to provide a clear steer to the readers of their reports.

Although only five companies surveyed mentioned integrated reporting, the vast majority, 80%, already discuss value creation in their reports.

Find our full survey and plenty of best practice examples at www.deloitte.co.uk/annualreportinsights

Narrative reporting

Telling the story

With the average annual report again increasing in length from 122 to 132 pages this year, partly due to the revised remuneration reports, it is becoming more and more important for companies to consider the clarity of the message that they are communicating. Demonstrating the linkage between areas such as strategy, KPIs and principal risks can be very helpful in this area – SEGRO plc provide an effective example of how this can be done through the use of a table showing these relationships. Effective use of electronic communication is also important – some ideas for electronic content include videos to illustrate key messages, as presented by Aviva PLC, or an interactive map of the company's operating locations as shown by CLS Holdings plc.

Good examples: SEGRO plc, Aviva PLC and CLS Holdings plc

Summary information

All but one of the companies surveyed this year included a summary section in their report, with most of these including narrative information such as an overview of the business model or strategy alongside a summary of financial performance. Only 29% of companies used their summary pages to show how the different elements of their annual report linked together.

Good example: BT Group plc

The business model

94% of reports clearly identified the discussion of their business model, with the majority of these giving a comprehensive description of it. 59% included a visual representation of their business model, something that can be a very effective communication tool when used appropriately.

Good examples: Rexam PLC, International Personal Finance plc and North Midland Construction PLC.

64%
demonstrated some linkage in their report

29%
linked their report together in their summary pages

59%
included a visual representation of their business model

Objectives and strategy

Good examples: Croda International Plc and IP Group PLC

A discussion of the objectives of the business and its strategies for achieving these objectives is a key part of the strategic report. It often interlinks with the business model, showing why the company is doing what it is doing. 99% of companies identified some objectives in their report, with the majority giving both financial and non-financial objectives. 41% of companies discussed not just objectives for the immediate future but also for the long term, an area of focus for integrated reporting.

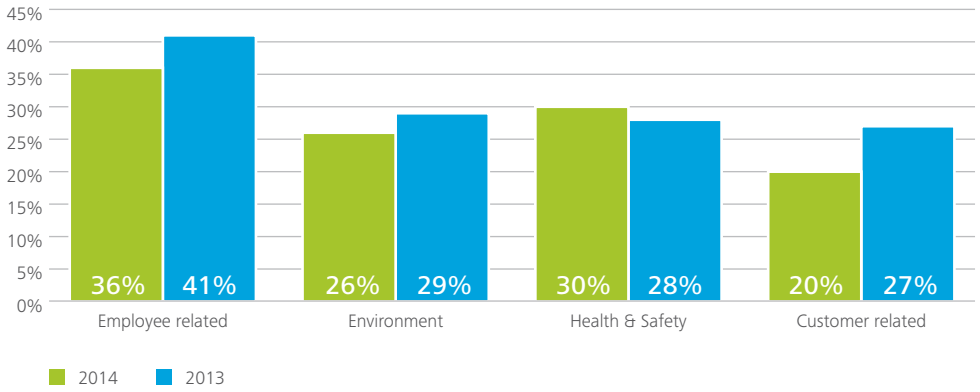
Key performance indicators

Good examples: Cobham plc, IP Group plc and Brewin Dophin Holdings PLC

The identification and presentation of key performance indicators in a company's annual report is a prime candidate for the linkage discussed above. The way in which KPIs measure the success of the business' strategy was highlighted by 47% of companies – see Cobham plc for an example of how this can be done. Some also showed how their principal risks might affect performance of their KPIs, while others clearly illustrated the links between their KPIs and directors' remuneration – IP Group plc demonstrate how both of these linkages can be presented.

On average companies identify five financial and two non-financial KPIs – the graph shows some of the most popular non-financial measures selected. Encouragingly, the percentage of companies clearly defining their KPIs rose from 51% to 60%. 30% of companies also gave information on future targets for their KPIs, with Brewin Dolphin Holdings PLC giving a particularly innovative illustration.

What type of non-financial KPIs are included within the annual report?



Principal risks and uncertainties

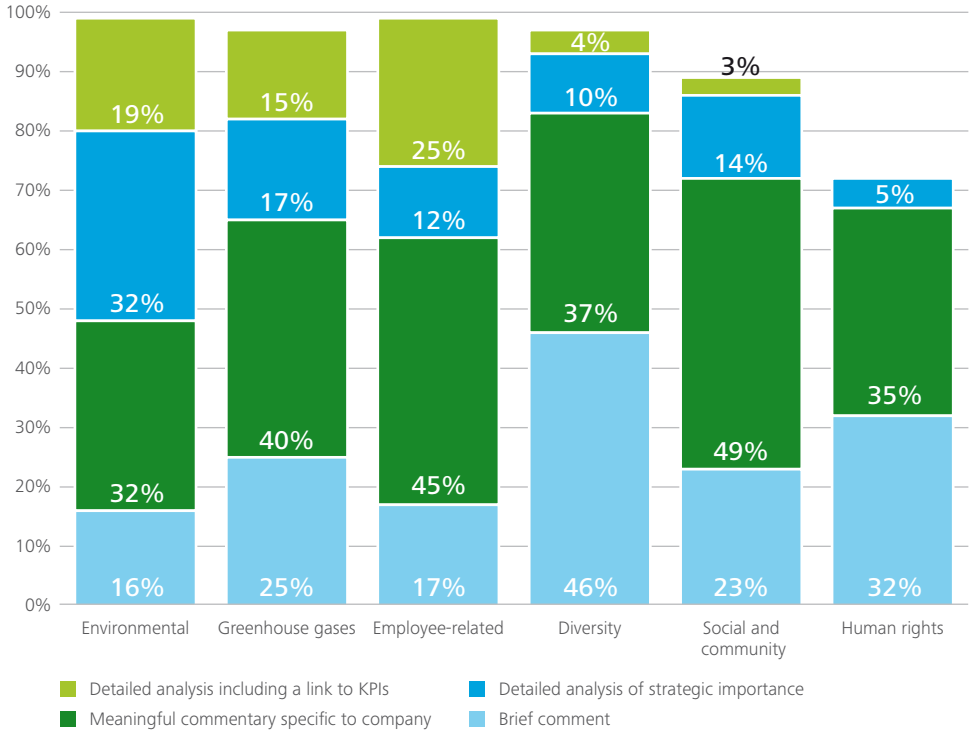
On average companies presented nine principal risks, with even the majority of the FTSE 100 companies surveyed keeping the number identified in single figures. Demand, regulation and operational issues were the most common principal risks identified, with the number of companies identifying the state of the economy as a key source of uncertainty falling noticeably (from 72% to 57%).

Identification of financing issues and going concern as principal risks also fell. 33% of companies gave information on the relative changes in their risk priorities, but only 6% also gave absolute information – Domino Printing Sciences plc give a good example of how this can be done. Recent FRC pronouncements will lead to a change in risk reporting for years beginning on or after 1 October 2014.

Good example: Domino Printing Sciences plc

Corporate social responsibility

How much detail have companies given about their corporate social responsibility?



Good example:
Mitie Group plc

With specific new requirements to give human rights, gender diversity and carbon emissions information applicable this year, it is unsurprising to see a significant improvement in the quality of corporate social responsibility disclosures this year. The best disclosures, such as that given by Mitie Group plc, did this by including only the essential information in the annual report, with the detail contained in a separate standalone responsibility report.

Some companies seem to have been a little confused by the exact details of the new requirements, with a significant number of disclosures not obviously complying with the finer points of the new law, for example disclosing the percentage of employees that are female, rather than absolute numbers.

Going concern

Going concern and the implementation of the recommendations of the Sharman review have continued to be areas of significant regulatory activity over the past year. After three consultation drafts the FRC has finalised its revisions to the UK Corporate Governance Code, with a new 'statement of ongoing viability' to support the existing going concern statement.

Good example:
National Grid plc

With the continuing uncertainty during the period, it is unsurprising (although disappointing) that we saw little improvement in the quality of going concern disclosures during the period. Only 69% of companies gave a clear, high quality going concern statement and the only one that made an explicit reference to the Sharman report was National Grid plc.

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Corporate governance

Compliance with the Code

Despite the new recommendation in the preamble to the 2012 Code, the percentage of those companies indicating non-compliance who gave a real justification for the non-compliance remained static at 60%. Johnson Matthey and Barclays plc provided justifications for their temporary non-compliances.

Good explanation examples: Johnson Matthey and Barclays plc

Board diversity

Diversity continues to be a hot topic, in the context of board composition as well as the wider staff population. It is important to remember that when the Code talks of board diversity, it is diversity in its broadest sense which is important. It was encouraging to see that 52% of companies surveyed made reference to the wider aspects of diversity in their disclosures. Lonmin plc provided some interesting graphics on the diversity of the board. Marks and Spencer Group plc also provide a good example of disclosures covering matters such as board experience, nationality and length of tenure.

Good examples: Lonmin plc and Marks and Spencer Group plc

Fair, balanced and understandable

One of the provisions of the 2012 Code which prompted a significant amount of debate was provision C.1.1 that requires the directors to make a statement that "the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the company's performance, business model and strategy." All but four of the companies, all outside the FTSE 350, provided the new fair, balanced and understandable statement this year. 23% of companies providing the statement included further details of the process undertaken to support the statement within the corporate governance section of the annual report. Including such detail can give shareholders confidence that a robust process has been undertaken for the preparation of the annual report.

Good examples: Spectris plc and Anglo American plc

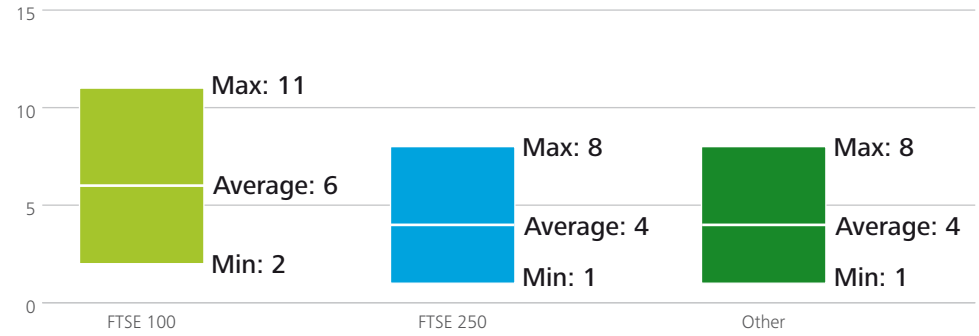
It was encouraging to see that 52% of companies surveyed made reference to the wider aspects of diversity.

Significant issues considered by the audit committee

The revisions to the Code require audit committees to describe the significant issues considered in relation to the financial statements and how those issues were addressed. In addition, it is important to note that the 2013 revisions to auditor reporting, which came into force for periods ending on or after 30 September 2013 (i.e. at the same time as the 2012 Code) now require auditors to report on the key risks of material misstatement which they focused on and which required the most audit effort.

Although there was a high degree of cross-over between audit committee significant issues and the auditor's audit risks, 43 audit committees discussed an average of 2 significant issues which were not reported as risks by the auditor.

The average number of issues disclosed across the three company size categories was as follows



Good examples: ITV plc and Tullow Oil plc

Good examples of disclosures on significant issues were given by ITV plc and Tullow Oil plc. In particular, both these companies make it clear which issues are recurring issues for the audit committee and which are one-off items for the particular year.

Audit tendering

The frequency of audit tendering and the relationship between the external auditor and the companies they are auditing has been a key area of focus since the 2008 financial crisis. The 2012 Code introduced a requirement for companies to put their audit out to tender at least once every ten years and to provide disclosures around the length of the existing audit relationship and details on tendering policy. In addition the European Commission and the Competition & Markets Authority are also introducing new rules around mandatory tendering and rotation. At the time of writing the former's detailed implementation rules are still to be finalised.

Only 11% of companies surveyed committed to a tendering frequency going forward and all of these were every 10 years, as in the Code provision. 35% of companies provided an indication of when an audit tender would be undertaken typically taking advantage of the transitional arrangements allowed for by the Code provision and/or coinciding with the rotation of the current engagement partner. Some companies made the point that the current regulatory uncertainty on implementation of mandatory tendering and rotation meant that it was not convenient for a tender process to be undertaken at the present time.

Only 11% of companies surveyed committed to a tendering frequency going forward and all of these were every 10 years, as in the Code provision.

Financial statements

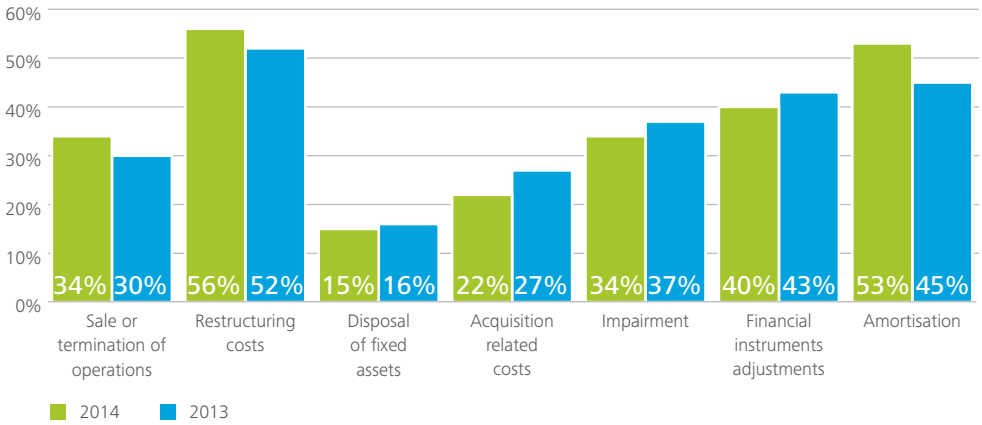
Good example:
National Grid plc

Non-GAAP measures

68% of companies compared to 61% last year presented non-GAAP measures on the face of their income statement – all of these companies defined the measure, making clear the items stripped out in order to arrive at it. Of those presenting non-GAAP measures, 79% provided justifications for *why* items had been stripped out.

As the figure below shows, the types of items that are stripped out was relatively consistent compared to the previous year.

What do non-GAAP measures strip out?

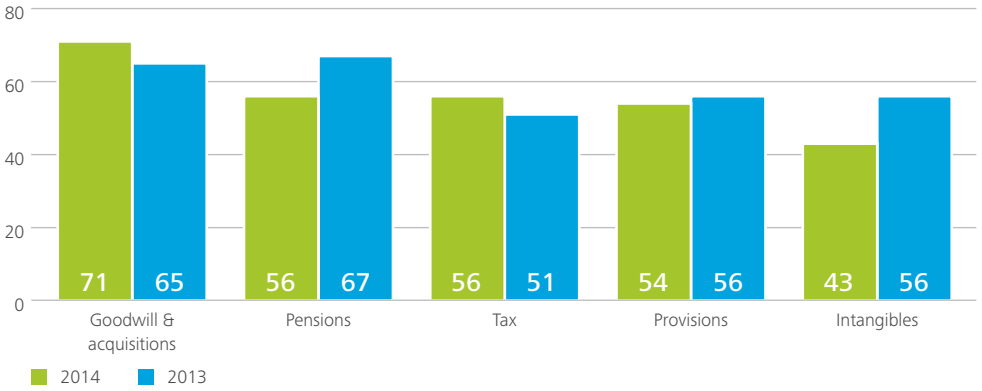


A few companies tried to be innovative in the way that they reported non-GAAP measures, for example Marks and Spencer Group plc included a separate box immediately after the income statement. This approach could be said to aid transparency in keeping non-GAAP measures clearly separated from GAAP measures.

Critical judgements and key sources of estimation uncertainty

Consistent with last year, the average number of critical judgements and key sources of estimation uncertainty disclosed was five, with a maximum of 14. The underlying areas were also relatively consistent with last year, as shown below.

How many companies include the following items as critical judgements or key sources of estimation uncertainty?



Linkage and innovation

Some companies have experimented by presenting narrative reporting in amongst their primary statements, for example Vodafone PLC. An FRC lab report stated that a small proportion of investors prefer this presentation.

69 companies in our sample reported significant restructuring costs, impairment charges or exceptional items in their financial statements. Encouragingly, in all but one instance these items were commented on in the front half of the annual report with what was deemed a reasonable degree of prominence, rather than being buried.

Six of the ten companies that had goodwill but no sensitivity analysis had nevertheless identified the potential impairment of goodwill as a key source of estimation uncertainty. This suggests that there may be some disconnect between the different disclosure elements in the financial statements.

Other key findings

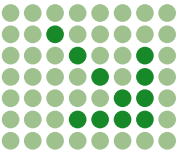
36
companies surveyed (2013:46) had business combinations in the year.

Only **79%**
provided disclosures which were considered to meet all, or nearly all, of IFRS 3's extensive disclosure requirements.

53%
of companies with goodwill provided either detailed or high-level sensitivity analysis around goodwill impairment testing.

15%
of companies with intangible assets (other than goodwill) disclosed that one or more classes of intangible assets had been assessed to have an indefinite life…

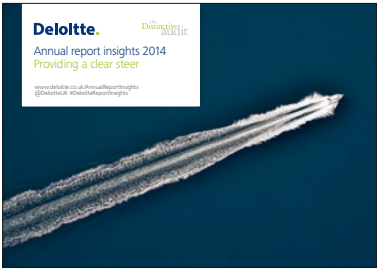
92%
of companies with such assets included the reasons supporting their judgement – a good example being LSL Property Services plc.



91
companies surveyed recognised an impairment loss of some sort in the year, most commonly in relation to trade receivables.

To find out more

'Annual report insights 2014 – Providing a clear steer' is available at www.deloitte.co.uk/annualreportinsights or on www.ukaccountingplus.co.uk, your one stop shop for news and resources on UK accounting, reporting and corporate governance. An electronic version of this highlights booklet is also available.



Other related Deloitte publications available on UK Accounting Plus include:

- Our *Practical guide on preparing a strategic report.*
- Our previous surveys *It has begun* and *It has begun … the next wave*, which look in detail at the new narrative reporting and Code requirements.
- *Our Governance in brief* on the changes to the Code regarding going concern disclosures.
- Our *Corporate Governance Disclosure Checklist.*
- *The new remuneration report – First impressions and Second impressions*, our surveys which look in detail at the new remuneration reporting requirements.
- Our *IFRS compliance, presentation and disclosure checklist*.

Useful external publications include:

- the FRC *Guidance on the Strategic Report*, available at https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Guidance-on-the-Strategic-Report.pdf
- the GC100 and Investor Group *Directors' Remuneration Reporting Guidance*, available at http://uk.practicallaw.com/6-540-9731

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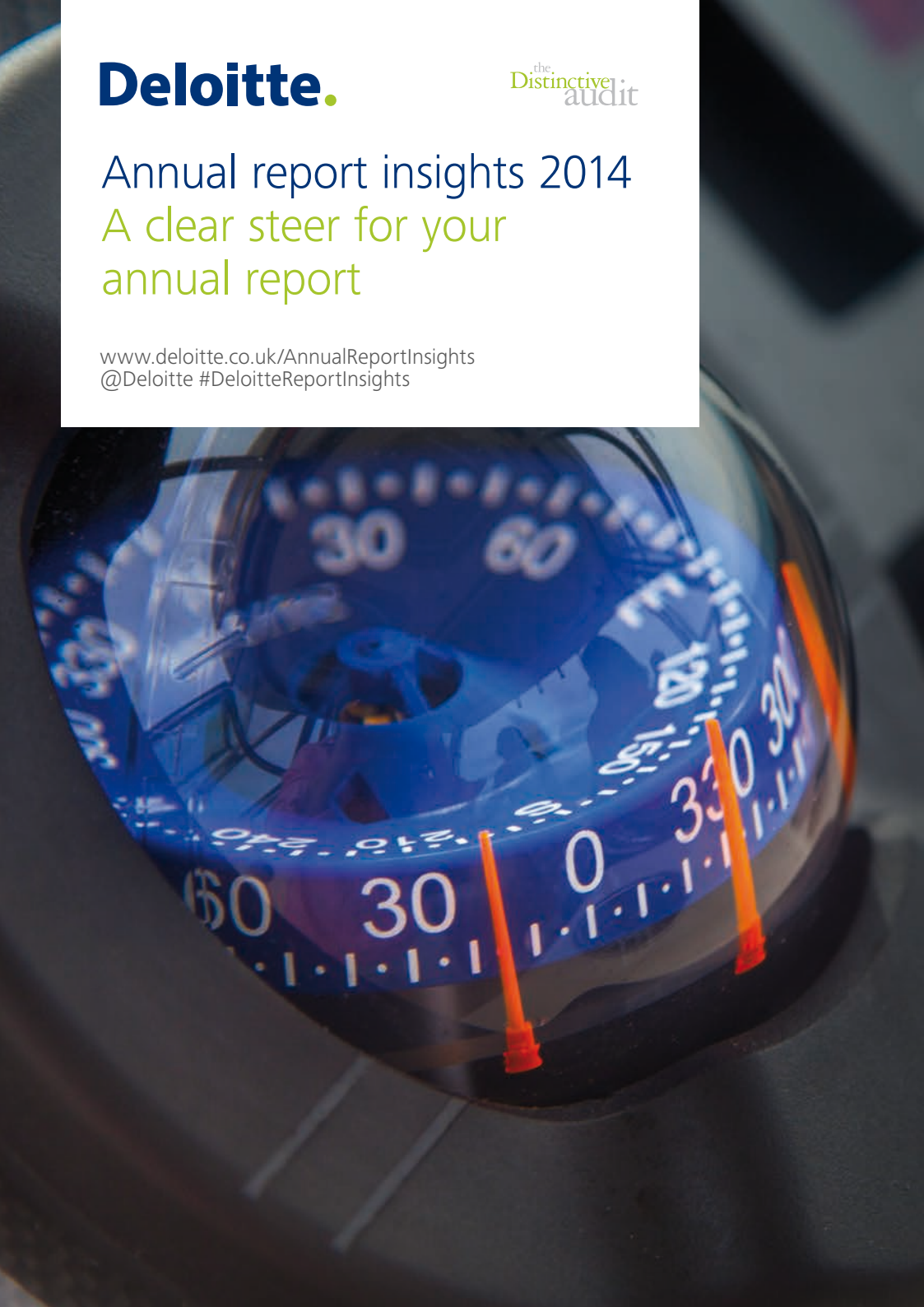

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A clear steer for your annual report

Drawing on our annual report survey, the highlights of which are in the other half of this booklet, this half brings together various ideas to help you ensure that your annual report meets the needs of investors, regulators and other stakeholders.

It includes:

- some thoughts on developing the content of the report, including the latest regulatory changes, regulators' areas of focus and ways to cut clutter;
- a section setting out our thoughts on the 'fair, balanced and understandable' statement and the process that gives the directors comfort to make this statement; and
- a section discussing the annual report preparation process, including a possible timetable for this.

Annual report contents

In order to reflect the differing appetites as to how far preparers want to go in improving their reports, our tips on the content are split into four levels:

1. **The bare minimum – complying with new and existing requirements plus key concerns of regulators;**
2. **Upping your game – looking at further regulatory areas of focus, including linkage;**
3. **Clearer communication – considering the qualitative characteristics of effective communication and ways to cut clutter; and**
4. **Going the extra mile**

Obviously these are not necessarily a strict hierarchy – there is nothing to stop you picking and choosing from the suggestions within them.

Level 1

The bare minimum – complying with new and existing requirements plus key concerns of regulators

Producing a top quality annual report is no mean feat, and sometimes some of the legal niceties can be overlooked in the quest to produce a clear and concise report. Based on our survey findings we've picked out some easy wins, reflecting areas that many companies currently slip up on, but which with a bit of planning and thought could be rectified with relative ease. Following this we identify several newly effective requirements that will need to be addressed and the key topics most likely to attract the attention of regulators.

Existing requirements – pitfalls to avoid

1. Make sure it is clear that the **strategic report has been approved** by the board – in 27% of the reports we surveyed this year it was not. Unlike the old business review, the strategic report is legally separate from the directors' report and needs separate approval.

2. Ensure that all sections of the report clearly contain (either directly or by cross-reference) all of **the information that is legally required**. For example, where information that is legally required to be in the directors' report is considered to be of 'strategic importance' and as a result is presented in the strategic report instead, the law requires that the directors' report include a statement setting out which information has been treated in this way. Only 43% of the reports surveyed included this.

3. Check that your **gender diversity disclosure** gives the detail required. One common pitfall is that the law specifies that absolute numbers must be given, not just percentages. Another is that, where information is given for categories of employee that are not those required by the law (e.g. 'senior management' as specifically defined), it must nevertheless still be possible to obtain the legally required figures from those presented.

4. Explanations of non-compliance with the Code – it is important to remember that these need to be a **meaningful explanation** rather than just a statement of fact.

5. For the purposes of the disclosures on board diversity policies for the Code, it is important to remember that diversity is referring to **diversity in its broadest sense**, not just gender.

6. If presenting an adjusted basic EPS figure be sure to also provide the **diluted adjusted figure** – 19% of companies with adjusted EPS figures forgot to do this.

New requirements

After the high volume of changes last year, 2014/15 sees significantly fewer.

However, they could still trip you up if you're not careful!

1 Changes to the Listing Rules – for years ending on or after 1 September 2014, there is a new requirement that a company's report must either contain all of the information required by provision 9.8.4R of the Listing Rules in a single identifiable section or it must include a cross-reference table indicating where that information is set out. There are also extensive new disclosure requirements for companies with a 'controlling shareholder' as defined by the Listing Rules.

2 The 'package of five' – for many UK companies, this will be the year of adoption for the new IFRS consolidation standards, each of which brings its own challenges. Notably:

- IFRS 10 *Consolidated Financial Statements* necessitates a reconsideration of which entities form part of a consolidated group, based on a single definition of control and new guidance on concepts such as 'de facto' control, protective rights and decision making as 'agent' for another investor;
- IFRS 11 *Joint Arrangements* requires a determination of the rights and obligations of the parties to such an arrangement. This is then used to decide whether equity accounting or a method similar to proportionate consolidation is applied to the arrangement; and
- IFRS 12 *Disclosure of Interests in Other Entities* introduces extensive new disclosure requirements on the make up of a group, including describing the significant judgements made in applying its sister standards IFRS 10 and IFRS 11.

3 FRS 101 – eligible companies wishing to adopt FRS 101 *Reduced Disclosure Framework* in their 2015/16 separate financial statements are required by that standard to notify shareholders of their plans to do this in advance. Companies may wish to take advantage of the opportunity to communicate this in their 2014/15 reports, rather than having to prepare a separate communication.

These issues, and more, are discussed in the regulatory overview in chapter 3 of *Annual report insights 2014 – Providing a clear steer*, together with links to further information and resources.

Regulatory scrutiny

When thinking about preparing an annual report that complies with relevant requirements, it is of course necessary to remember the regulators who seek to ensure that compliance.

A regulator can and will, look at anything they see fit, but experience shows that the same areas crop up again and again and should be factored into the planning for any annual report.

1 **Impairment models**, particularly those 'value in use models' incorporating a 'hockey stick' growth forecast (high growth in the early years). Where companies have a model which has such a profile, they should be particularly prepared for regulatory scrutiny. Regulators will focus on value in use calculations they perceive to have a higher risk of impairment, challenging key assumptions and any applicable missing sensitivity disclosures.

Impairment is also an area which highlights the need for consistency in an annual report. Are the forecasts and other assumptions in testing goodwill for impairment the same as those used for other areas such as deciding whether to recognise deferred tax assets? If not, could you explain why?

2 The use of **non-GAAP measures** has been the subject of several recent pronouncements. The FRC has been focussing on how companies determine what to strip out when presenting such measures, with challenges being raised where recurring items such as amortisation of intangible assets are excluded. Consistent application of a policy in this regard and provision of comparatives is important. Where exceptional debits are stripped out, so should be any similar credits, such as the reversal of an impairment, even if they arise in different periods.

ESMA's proposals, expected to be finalised before the year is out, focused more on the presentation of non-GAAP measures in a company's communications, in particular their prominence compared to GAAP measures. Other concerns include situations where measures used in the narrative reporting are different to those presented to management (as disclosed in the IFRS 8 note) and those presented on the face of the income statement. A balanced commentary from management would also be expected in discussions that utilise such adjusted measures.

3 **Revenue recognition**, particularly in cases where there has been a change in business model, is another area where regulators will be on the lookout for unusual policies and for aggressive revenue recognition, particularly when a new line of business may be taking time to build momentum.

Level 2

Upping your game – looking at further regulatory areas of focus, including linkage

Companies should also bear in mind the other areas regulators are focusing on at the moment:

1	**KPIs** should be clearly and consistently defined year on year, with an explanation of their calculation and reconciliations to statutory measures where appropriate. Linking them to the company's strategy, business model, objectives and remuneration policy is a current hot topic.
2	Despite improvements in risk reporting in recent years, **principal risks and uncertainties** remain an area of regulatory focus. Companies should take care to make clear their "principal" risks and uncertainties and to describe their mitigating activities.
3	**Directors' remuneration reporting** was expanded significantly last year and regulators will continue to scrutinise reports in the second year of the new regulations.
4	**Critical judgements and key sources of estimation uncertainty** – these should clearly identify where management has exercised judgement and its effect. Boilerplate should not be used. See also the linkage points below.
5	In the second year of application of the revisited version of IAS 19, **pensions accounting and disclosures** are set to come under scrutiny. Regulators are also set to focus on any pensions "structuring" that has been set up for a desired accounting effect and on disclosure of minimum funding requirements.
6	**Cash flow statements** and compliance with IAS 7 *Statement of Cash Flows* classification requirements. It is tempting to assume that, since IAS 7 contains fewer headline categories than FRS 1 *Cash flow statements*, it is more flexible but in reality there is unlikely to be much of a grey area as to whether a transaction is operating, investing or financing in nature. Also, make sure that all numbers purporting to be cash flows actually are cash flows!
7	**Fair value measurements** under IFRS 13 and disclosure of related risks under IFRS 13 and IFRS continue to be particularly relevant for financial institutions.

Linkage

The importance of linking the information in your annual report together is something that is becoming more and more evident as the content requirements proliferate and reports keep getting longer as a result. For example, promoting greater cohesiveness in the annual report through improved linkage is one of the main objectives of the FRC's Guidance on the Strategic Report, which provides plenty of examples of effective linkage. Regulators are challenging companies where information in the 'front half' and 'back half' of the annual report does not appear to be consistent. To help you assess how good the linkage is in your report, we have set out eight simple things that you can check:

1 How many of your KPIs have you presented in the summary section or highlights part of your report? If the KPIs have been identified correctly, we would expect them to give a good overview of the company's performance in the year (perhaps alongside a more general summary of financial performance).

2 Where non-GAAP measures are used in your summary section, are these the same as those presented in your income statement or the measures reported to the chief operating decision maker reported in your segmental analysis? If summary information is presented on a different basis to the financial statements, this is likely to require justification and may be challenged.

3 Is it clear how your KPIs measure the achievement of your objectives and the success of your strategy? This is only one of many links that can be made between content elements of the strategic report but is perhaps the most easy to assess. You should be able to identify a strategic priority that is measured by each KPI – if not, is the measure really key? Or is there something that needs to be added to the description of the company's strategy?

4 Are the measures used to assess directors' remuneration consistent with the company's KPIs? Where the performance of the company is measured in particular ways to assess the impact of the directors and determine their reward, this is likely to be a good indication that these measures are key to understanding the performance of the company. This is also implied by the remuneration reporting regulations and the revised Code.

5 How consistent are the critical judgements and key sources of estimation uncertainty in the notes, the key areas of focus identified by the audit committee and the key risk areas identified in the audit report? Again we would not expect 100% consistency but if, for example, the auditors have identified stock obsolescence as a key risk, we might expect to see this mentioned by the audit committee and in the notes.

6 Is the extent of disclosure in the notes to the accounts consistent with the identification of areas of judgement or uncertainty? We would expect to see proportionately more disclosure given for areas identified as high risk. For example, if goodwill impairment is identified as a key judgement, we would typically expect to see more fulsome disclosure in the goodwill note e.g. the sensitivity analysis presented giving information on the likelihood that an impairment could arise.

7 Does the audit committee's listing of significant financial reporting issues cross-refer to other relevant disclosures in order to avoid duplication and to improve the linkages between sections of the annual report?

8 Are the discussions around risk management, principal risks and uncertainties, including the risk that the company's strategy may not succeed, and going concern suitably joined up?

If you find areas where your linkage could be better, consider introducing signposting to indicate to users where one area of the report links to another, or restructure the report to group related disclosures together and use cross-referencing to ensure that the legal requirements are still met.

Level 3

Clearer communication – considering the qualitative characteristics of effective communication

Once you have navigated the new requirements and dodged the regulatory pitfalls, it is time to focus further on the big picture and how well your report as a whole communicates with users. Here are some broad-brush areas that may increase the impact of the information presented in the annual report.

Break up the text a bit. Long paragraphs of narrative are never easy to read – it's important to include some graphics or even just blank space to make those pages a bit less 'busy'. However, see (2) below!

Make sure graphics are relevant. Lots of snazzy graphs can make a report look more lively but be careful to ensure that they are complementing and not confusing the key messages. A particular example of this is graphical representations of the business model – make sure these are clear and not confusing.

Tell a story. Ensuring that there is a consistent message throughout the report avoids users getting confused by information that is unclear or contradictory. Making sure that the report is well structured so that it flows naturally from one section to the next is also helpful in this regard.

Use your summary section to showcase the relationships between different elements of the report. Clearly setting out what is where is a great way to enable users to navigate quickly to the information they are interested in. It can also be a helpful way of demonstrating some of the linkages described in level 2.

Set the scene clearly and give disclosures context. Launching straight into the detail of how successful 'Project X' has been is dangerous if the reader might not know the background behind what Project X was trying to achieve.

Write in plain English avoiding jargon and explaining acronyms.
An understandable report written through the eyes of management is more engaging.

Ensure the key messages are clear to the user and not obstructed by immaterial, boilerplate clutter. (See ideas for cutting clutter below).

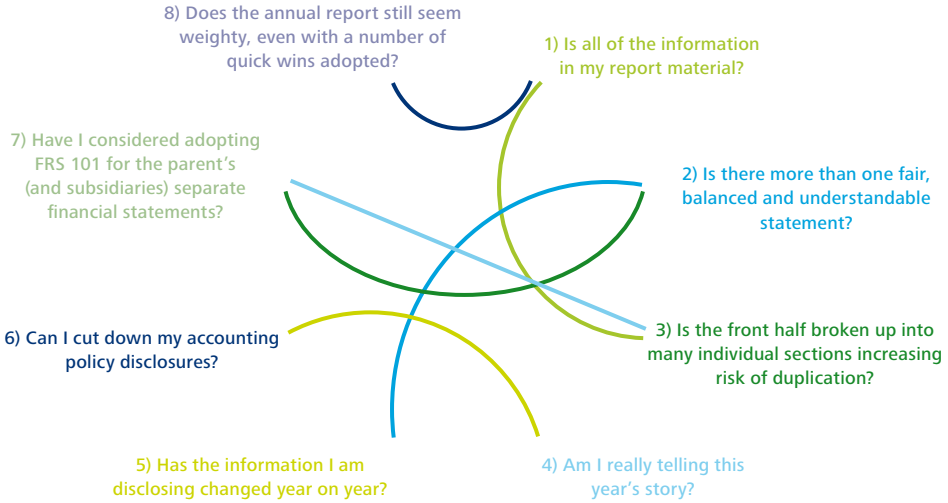
Also, think about the communication principles set out in the FRC Guidance on the Strategic Report, which note that the strategic report should:

- be fair, balanced and understandable;
- be comprehensive but concise;
- have a forward looking orientation, where appropriate;
- provide information that is entity-specific;
- highlight and explain linkages between information presented in different parts of the annual report; and
- be reviewed annually to ensure that it continues to meet its objectives in an efficient and effective manner and that it continues to be relevant.

The following diagram illustrates how the elements of the strategic report should be woven together. Many of these elements, in turn, link through to various other sections of the annual report.

Cutting clutter

Whilst going the extra mile in an annual report is to be commended, a continual challenge in today's world is to avoid overloading readers with information and leaving them in a position where they struggle to see the wood for the trees. Here are eight questions for preparers to consider when attempting to cut clutter from their annual reports.



1) Is all of the information in my report material?

As part of their disclosure initiative, in March 2014 the IASB issued an exposure draft of amendments to IAS 1 intended, among other things, to clarify that materiality considerations apply to all parts of the financial statements, including disclosures. Rather than approaching the standards as a checklist, preparers need to think carefully about whether disclosures are material, particularly in areas where the requirements are extensive such as share-based payments or pensions.

Materiality applies equally to the 'front half'. The FRC has included in its Guidance on the Strategic Report a section on the application of materiality to the strategic report. In particular, it relates the concept of materiality to the use of terms such as 'principal' (as in principal risks) and 'key' (as in key performance indicators) in the law.

2) Is there more than one fair, balanced and understandable statement?

The fair, balanced and understandable statement only needs to be made once, some companies had repeated reference to the need for the statement in the corporate governance section of the annual report and then the statement itself was also included in the directors' responsibility statement. Unless a company is planning to provide further details around the process undertaken to make the fair, balanced and understandable statement, there is little benefit in repeatedly making reference to it.

3) Is the front half broken up into many individual sections increasing risk of duplication?

The FRC is keen that companies avoid approaching the annual report in silos and instead have a single integrated process. Where, for example, the chairman, chief executive, finance director and heads of divisions have all provided statements in the front half, this can make it much harder to tell a consistent story without creating a lot of duplication. It may well be possible to integrate these contributions into the whole, increasing cohesiveness and reducing duplication. For example, the chief executive could introduce the strategic report rather than presenting a standalone CEO's review.

4) Am I really telling this year's story?

Don't just roll forward last year's report – there can be a tendency to disclose 'everything we disclosed last year plus some extra bits'. Be ruthless and cull information that was included last year but is no longer relevant or material this year. The FRC Guidance specifically mentions this as one of its communication principles, and the FRC's Financial Reporting Lab (in its report Towards Clear & Concise Reporting) recommends starting the process with a blank piece of paper each year.

5) Has the information I am disclosing changed year on year?

If not, could this sort of "standing data" be included in an appendix so that it does not interrupt the flow and be cross-referred to as appropriate? The FRC is encouraging companies to include such information, for example disclosures required by accounting standards that do not change significantly from year to year, in a separate part of the annual report. Where information is not required by law to be contained in the annual report, it could be presented on the company's website instead, with a brief summary in the annual report and a link to the online detail.

6) Can I cut down my accounting policy disclosures?

In their recent report Accounting policies and integration of related financial information, the FRC's Financial Reporting Lab noted that investors think accounting policy disclosures include unnecessary repetition of language from accounting standards where there is no choice or judgement involved in their application to the company. While all investors agree that significant accounting policies should be prominent within the report, many agree that non-significant policies, if included, could have less prominence, for example being included in an appendix and immaterial accounting policies not included at all.

7) Have I considered adopting FRS 101 for the parent's (and subsidiaries) separate financial statements?

Eligible parent companies may wish to take advantage of the new IFRS reduced disclosure framework and adopt FRS 101 before its mandatory date.

8) Does the annual report still seem weighty, even with a number of quick wins adopted?

Instead of sending the complete annual report to shareholders, subject to certain criteria, the strategic report together with certain supplementary information (this replaces the summary financial statements) could be sent to shareholders if after cutting clutter from the full annual report it nevertheless remains lengthy.

Level 4

Going the extra mile

Whilst some preparers of annual reports will always lean towards providing the bare minimum and others will want to go above and beyond, stakeholders often value those reports that follow best practice guidance. Those companies that go the extra mile adopt new requirements early, take on board non-mandatory guidance and provide additional information that is thought to improve a user's understanding of the performance and strategy of the business. Below are some areas where preparers could choose to impress their readers and respond to investor demands – some easier to achieve than others. Our main survey document provides examples of the following disclosures as indicated by the cross-references provided.

- Following all the recommendations of the **FRC's Guidance on the Strategic Report** regarding the additional information that can be presented for each of the content elements of the strategic report (see chapter 7).
- Setting out the **market conditions** which are affecting the business and how these have shaped its strategy (see chapter 7).
- Ensuring that the business model clearly sets out information on **value creation**, including not just how the company creates value in the short term but how it will preserve this in the medium and long term (see chapter 7).
- Integrating the **concepts embodied in the IIRC's Integrated Reporting** Framework into the narrative report to ensure that it is relevant to all of a business' stakeholders (see chapters 3 and 7).
- Communicating **risk priorities** by giving information on the likelihood and potential impact of the principal risks and uncertainties identified (see chapter 8 and chapter 3 for a discussion of what is set to change in this area).
- Incorporating the **recommendations of the 2014 Code** into disclosure around going concern in advance of their effective date (see chapters 3 and 10).
- Reaching out to shareholders to find out whether they would find it more useful to see **financial commentary** presented alongside the financial statements, rather than separately in the narrative section (see chapter 14).
- Including a **net debt reconciliation**, which many investors say is of interest to them (see chapter 14) and is on the IASB's agenda as a possible future requirement of IFRSs.

Fair, balanced & understandable

A reminder of the requirement

Under provision C.1.1 of the Code, boards of premium listed companies are required to make the following statement in the annual report:

"The board confirms that the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the performance, strategy and business model of the company."

When drafting the annual report, companies need to bear in mind that the board has to confirm that the annual report, as a whole is fair, balanced and understandable. The FRC says that it is a matter of judgement for boards as to what 'fair, balanced and understandable' means in the context of annual reports. In making the statement, we believe that boards should focus on developing a more coherent and holistic annual report which clearly sets out how the business has performed during the year and the extent to which objectives have been met. Here are some questions that the board and/or audit committee might ask themselves when making the statement.

Dictionary definitions

Fair
Not exhibiting any bias, reasonable or impartial, done according to the rules

Balanced
Even-handed, taking account of all sides on their merits without prejudice or favouritism

Understandable
Having a meaning or nature that can be understood, able to be accepted as normal, reasonable or forgivable

Initial considerations

- Is the board interpreting this requirement consistently amongst themselves?
- Have the CEO and Chairman input into and agreed on the overall messages and tone of the annual report?
- Is there a clear framework for identifying key themes and the sections of the annual report in which those themes should be reflected?
- Has the reporting timetable been amended to allow sufficient time for planning out and review of the annual report as a whole? (See the later section on the annual report preparation process).
- What verification processes are going to be used, if any, to support the statement and is there a need for an independent review of the annual report prior to finalisation?
- Will a paper be presented to the board and/or audit committee on fair, balanced and understandable?
- Will the board be in a position to justify their statement in the future if challenged by the financial reporting review panel?

Fair

- A "fair" story does not omit important elements – Is the whole story being presented? Have any sensitive material areas been omitted? Is this justifiable?
- Is the annual report consistent with messages already communicated to investors, analysts and other stakeholders?
- Segmental reporting – are the business segments described in the business review consistent with those used for financial reporting in the financial statements? Are the messages in the front half reflected in the segment performance? Are the KPIs disclosed at an appropriate level based on the segments reported?

Balanced

- Is the annual report properly now a document for shareholders?
- Is there a good level of consistency between the front and back sections of the annual report? Do you get the same message from reading the two sections independently?
- Do 'highlights' or summary information capture the big picture of the company appropriately?
- Is there an appropriate balance between statutory and adjusted measures and are any adjustments explained clearly and with appropriate prominence? This is likely to be an area of further focus by accounting regulators across Europe.
- Where case studies or examples are used to illustrate activities or processes, are these of strategic importance and do not overemphasise immaterial matters?

Understandable

- Is there a clear and cohesive framework for the annual report? Are the important messages highlighted and appropriately "themed" throughout the document?
- Is information set out in the annual report easy to find and do sections link together well?
- Is the report written in accessible language? Are the messages clearly drawn out? Excessive use of specialist terms, acronyms and other jargon can make the annual report impenetrable – where the use of such language is necessary, is there a glossary that indicates how they are defined for clarity and consistency?

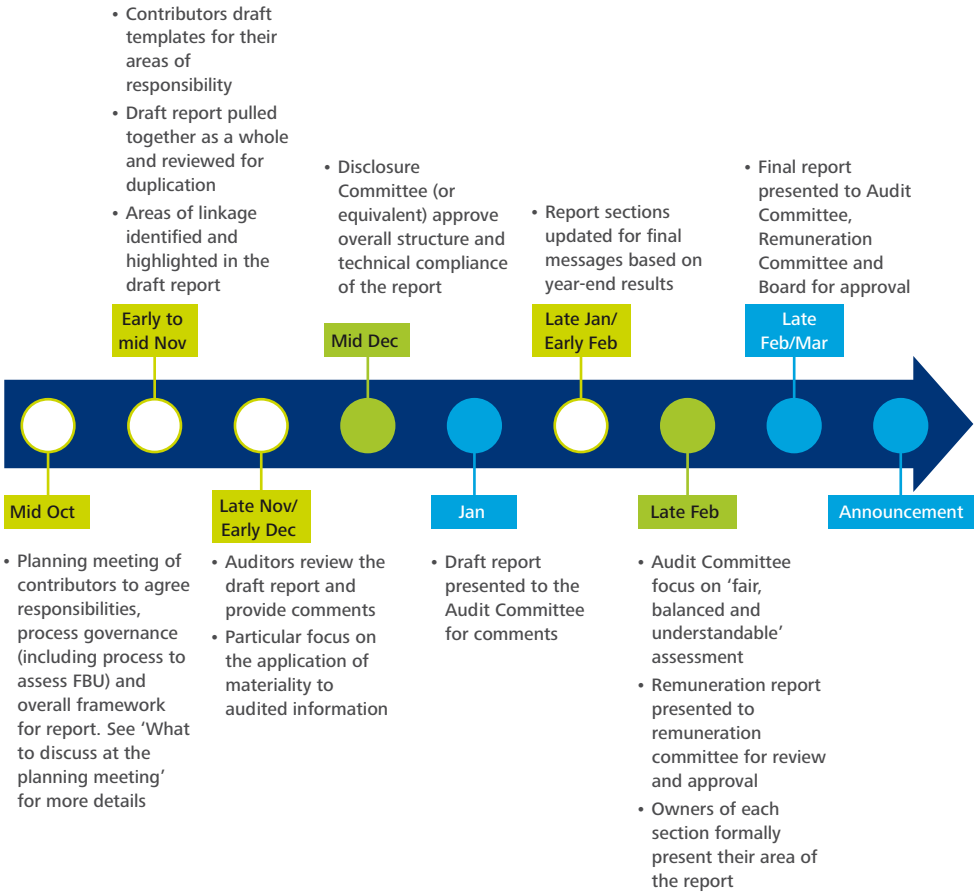
The annual report preparation process

When implementing the recommendations set out in the previous sections regarding the content of the annual report, it is important to be working to an appropriate timetable. Getting as much as possible done in advance of the year end when there is less pressure on the timetable allows this to be done more effectively, as well as reducing the burden during the post year-end reporting cycle. We have set out below a possible timeline for the annual report preparation process, based on a December 2014 year-end.

What to discuss at the planning meeting

- Decide which 'level' (see the first section of this guide) you aspire to be. Whichever level you choose, make sure you have identified any new regulatory requirements to be incorporated.
- Agree the key messages and themes (as far as they can be known at this stage) to flow throughout the report including getting Board buy-in as necessary.
- Discuss and agree how materiality will be applied.
- Meet with the design team to discuss the visual style of the report, including the creation of any new visual elements needed.
- Plan how you will avoid the 'silo effect':
  - arrange for regular communication between all those involved;
  - create a storyboard straw man identifying all elements to be included in the front half at the beginning of the process;
  - identify the links to be made in the report; and
  - identify who will do a 'cold read' of the report to assess duplication, conciseness, FBU and clarity of message.

Possible timeline for the annual report preparation process



Overcoming the silo effect

- Regular communication between all those involved
- Create a storyboard at the beginning of the process
- Identify the links to be made in the report
- Identify who will do a 'cold read' of the report to assess duplication, conciseness, FBU and clarity of message